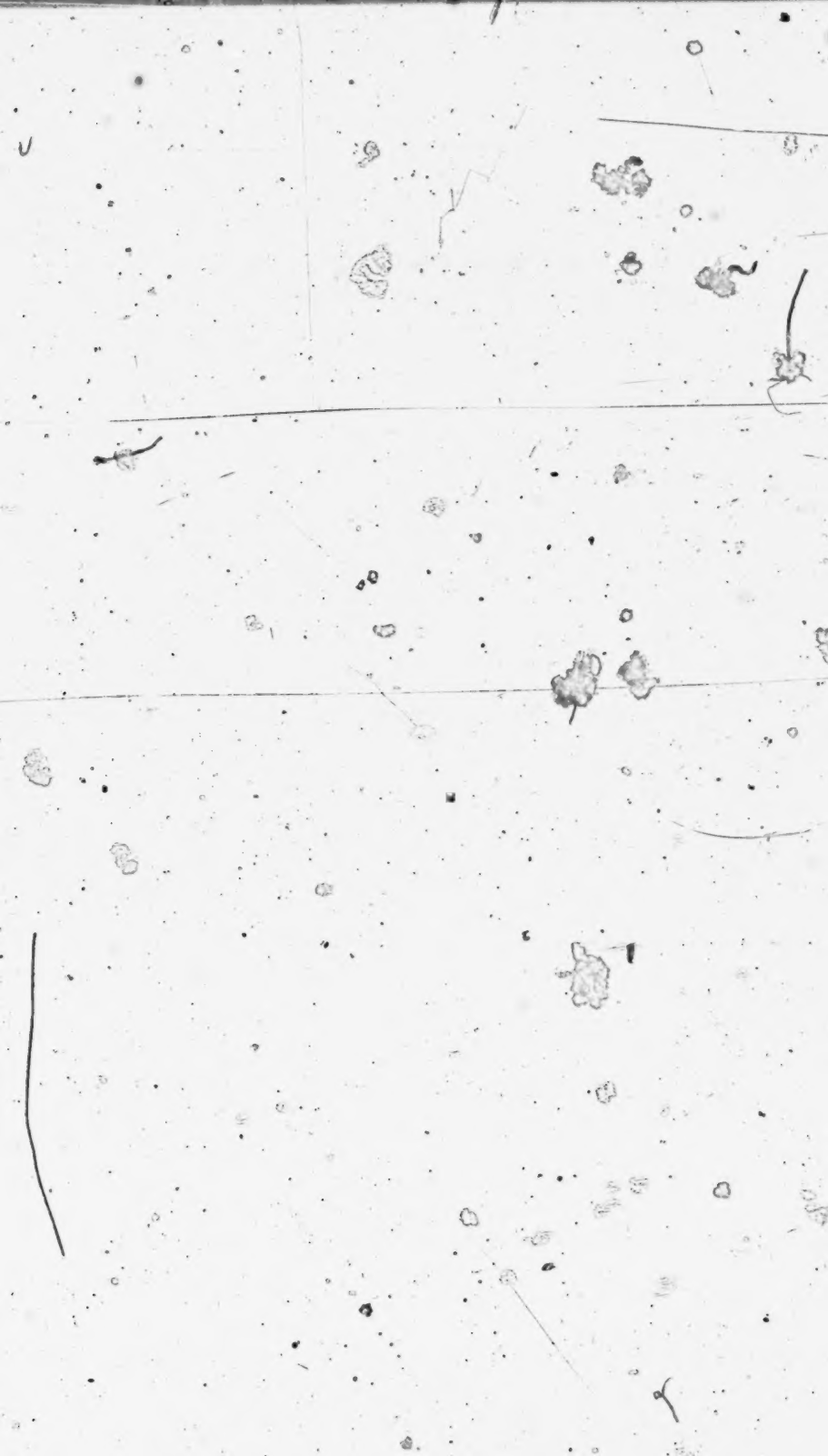
INDEX

	Original	Print
Record from the United States District Court for the Northern District of Oklahoma:		
Complaint	1	1
Exhibit A—Claim for refund	3	2
Attachment—Statement of Atlas Life Insurance Company	4	3
Amendment to complaint	9	9
Answer	10	10
Pre-trial order	11	11
Opinion, Bohanon, J	15	14
Judgment	23	22
Notice of appeal	23	22
Statement of points	24	23
Excerpts from transcript of trial proceedings	25	24
Appearances	25	24
Testimony of Johnson D. Hill, Jr.—direct	26	25
Andrew Delaney:		
Direct	32	30
Cross	53	52
Robert D. Allen:		
Direct	62	62
Cross	64	65
Clerk's certificate (omitted in printing)	74	65
Plaintiff's Exhibits 6, 7, 9, and 10—U.S. Life Insurance Company Income Tax Return for the year 1958 for Atlas Life Insurance Company	75	66
Proceedings in the United States Court of Appeals for the Tenth Circuit	103	94
Opinion, Murrah, Ch. J	103	94
Opinion, Breitenstein, concurring in result	123	114
Judgment	124	115
Order extending time to file petition for writ of certiorari	125	116
Order allowing certiorari	126	117

759-329—64——1



1 In the United States District Court for the Northern District of Oklahoma

Pleas and proceedings before the Honorable Luther Bohanon, Judge of the United States District Courts for the Eastern, Western and Northern Districts of Oklahoma, presiding in the following entitled cause:

ATLAS LIFE INSURANCE COMPANY, PLAINTIFF

vs.

UNITED STATES OF AMERICA, DEFENDANT

No. 5413, Civil

Complaint—Filed May 28, 1962

I. Plaintiff presents its Complaint against the United States pursuant to Title 28, Section 1346(a)(1) of the United States Code and Section 7422 of the Internal Revenue Code of 1954.

II. Plaintiff is, and at all times pertinent herein has been, a domestic stock life insurance company incorporated and existing under the laws of the State of Oklahoma, and is a life insurance company as defined in Section 801(a) of the Internal Revenue Code of 1954. Its principal office and place of business is located at 415 South Boston Avenue, Tulsa, Oklahoma.

III. Plaintiff's claim and this suit is for the recovery of $22,782.35, together with interest as provided by law, or such greater amount as is by law refundable, which amount was illegally and erroneously assessed and collected from Plaintiff for the calendar year 1958.

IV. Plaintiff completed and executed and timely filed its Federal Income Tax return for the calendar year 1958 on September 14, 1959, with the District Director of Internal Revenue for the District of Oklahoma.

V. The amount of income tax liability shown due on such return, $64,055.79, was paid by the Plaintiff to the Dis-
2 trict Director of Internal Revenue for the District of Oklahoma by payment of $50,000.00 on March 13, 1959, and payment of $14,055.79 on September 14, 1959.

On August 22, 1961, Plaintiff filed at the office of the District Director of Internal Revenue for the District of Oklahoma its claim for refund of its 1958 tax, claiming refund of such taxes illegally and erroneously assessed and collected from it in the amount of $22,782.35, or such greater amount as was by law refundable. A copy of the claim for refund is hereto attached, marked Exhibit "A," and made a part hereof.

VII. Defendant has taken no final action with respect to the claim for refund for the calendar year 1958 and more than six months have elapsed since Plaintiff filed its claim for refund. This action is filed within the period prescribed by Section 6532(a) of the Internal Revenue Code of 1954.

VIII. Exhibit 1 of the claim for refund, Exhibit A hereto, states the Federal income tax liability for Plaintiff for the calendar year 1958, after giving effect to minor adjustments and corrections, but before making the adjustments as required by Sections 804(a)(6) and 809(b)(4) of the Internal Revenue Code of 1954, and as required by law.

IX. Plaintiff states that in determining its income tax liability for the calendar year 1958, the Defendant has failed, neglected and refused to make the adjustments required by Sections 804(a)(6) and 809(b)(4) of the Internal Revenue Code of 1954 and a tax is thus imposed upon all or a part of interest accrued in 1958 from state or local bond obligations owned by Plaintiff, which interest is excluded from gross income under Section 103 of the Internal Revenue Code of 1954.

X. Plaintiff further states that in determining its income tax liability for the calendar year 1958, the Defendant has failed, neglected and refused to make the adjustments under Sections 804(a)(6) and 809(b)(4) of the Internal Revenue Code of 1954 and thus a tax has resulted on all or part of the interest accrued to Plaintiff in 1958 from state and local obligations, in violation of the principles set forth in National Life Insurance Company v. United States, 277 U.S. 313, (1928) and State of Missouri ex rel Missouri Insurance Company v. Gehner, 281 U.S. 313 (1930), which resulting tax is contrary to the Constitution and laws of the United States.

3 Wherefore, Plaintiff prays judgment against the Defendant in the amount of $22,782.35, or such greater amount as may be due, together with interest as provided by

law, and for its costs, and for such further and other relief to which plaintiff may be entitled.

DICKSON M. SAUNDERS,
of Doerner, Stuart, Moreland, Campbell & Saunders,
BYRON V. BOONE,
of Boone & Ellison,
THOMAS C. THOMPSON, Jr.,
of Bird and Thompson,
Attorneys for Plaintiff.

Exhibit A to Complaint

U.S. Treasury Department—Internal Revenue Service—Claim to be filed with the District Director where assessment was made or tax paid

The District Director will indicate in the block below the kind of claim filed, and fill in, where required.

[ ] Refund of Taxes illegally, Erroneously, or Excessively Collected.
[ ] Refund of Amount Paid for Stamps Unused, or Used in Error or Excess.
[ ] Abatement of Tax Assessed (not applicable to estate, gift, or income taxes).

Please Type or Print Plainly

Name of taxpayer or purchaser of stamps: Atlas Life Insurance Company
Number and street: 415 South Boston
City, town, postal zone, State: Tulsa 3, Oklahoma

Fill in applicable items.

1. District in which return (if any) was filed: Oklahoma City, Oklahoma
2. Name and address shown on return, if different from above:—
3. Period—if for tax reported on annual basis, prepare separate form for each taxable year: From 1–1, 1958, to 12–31, 1958
4. Kind of tax: Corporate Income Tax
4 5. Amount of assessment: $64,055.79; Date of Payment: 3–13–59—$50,000.00, 9–14–59—$14,055.79
6. Date stamps were purchased from the Government:

7. Amount to be refunded: $22,782.35 plus interest legally refundable.

8. Amount to be abated (not applicable to income, estate, or gift taxes):

9. The claimant believes that this claim should be allowed for the following reasons:

See statement and exhibits attached hereto which are made a part of this claim.

The Claimant further claims such additional refund or other relief to which it may be entitled, pursuant to the applicable provisions of the Internal Revenue Code and the regulations thereunder.

I declare under the penalties of perjury that this claim (including any accompanying schedules and statements) has been examined by me and to the best of my knowledge and belief is true and correct.

Signed ATLAS LIFE INSURANCE COMPANY,
By: HARRY L. SEAY, Jr., *President*.

Dated August 22, 1961.

Attachment to Exhibit A

[Copy]

Statement
Atlas Life Insurance Company
Claim for Refund—1958 Federal Income Taxes

Taxpayer hereby claims that it erroneously overpaid its 1958 income tax by the amount of $22,782.35. The amount of tax previously assessed and collected from claimant for 1958 was erroneous and illegal to the extent it resulted in an overpayment of tax for such year. Claimant overpaid its 1958 tax because no adjustments were made as required by Sections 804(a)(6) and 809(b)(4) of the Internal Revenue Code in computing its "life insurance company taxable income" to prevent imposition of tax on state and municipal bond interest accrued during the year, which is excluded from gross income under Section 103 of the Code. When the adjustments required by Sections 804(a)(6) and 809(b)(4) are made to eliminate the imposition of tax on state and municipal bond interest accrued by claimant in 1958, a lesser tax liability for 1958 results and refund of the excess taxes erroneously paid is hereby claimed.

5 Unless the proper adjustments are made, "the application of the definition of taxable investment income" (as defined in Section 804(a)(2)) and "the application of the definition of gain from operations" (as defined in Section 809(a)(1)) impose a tax on part or all of the state and municipal bond interest accrued by claimant in 1958 ($36,637.79).

Before the proper adjustments for tax exempt interest can be made three minor technical corrections are necessary. These corrections result in a lesser tax liability for 1958 and refund of the overpayment of 1958 taxes on account of the correction of these errors is also claimed. Attached hereto as Exhibit 1 is a revised 1958 tax return correcting these errors and omissions. Exhibit 1 does not take into account the adjustments provided in Sections 804(a)(6) and 809(b)(4). In detail Exhibit 1 makes the following corrections to claimant's 1958 tax return as filed:

(1) On its 1958 tax return as filed, claimant did not deduct 2% of its group accident and health insurance premiums as provided for in Section 809(d)(6) and Regulations Section 1.809–6. Under Exhibit 1, a deduction of 2% of claimant's group accident and health insurance premiums in the amount of $24,257.43 has been taken, increasing the deduction under Section 809(d)(6) from $23,492.31 to $47,749.74 (Schedule E, Line 25(a)).

(2) On its 1958 tax return as filed, claimant computed its investment income on the cash basis rather than on the accrual basis as required by Section 818(a) and Regulations Section 1.818–2. Exhibit 1 corrects this error by computing investment income on the accrual basis. This results in increasing the amount of state and municipal bond interest from $36,202.79 to $36,637.79 (Schedule A, Line 1(a), Column 4), decreasing the amount of interest from United States obligations issued after March 1, 1941, from $47,453.34 to $44,540.34 (Schedule A, Line 1(d), Column 4), and decreasing the amounts received from loans, notes, mortgages, etc., from $885,768.49 to $885,515.37 (Schedule A, Line 1(e), Column 4). These corrections result in an overall decrease in gross investment income from $969,424.62 to $966,693.50 (Schedule A, Line 1, Column 4).

(3) On its 1958 tax return as filed, claimant eliminated from assets due and unpaid premiums and reinsurance premiums due from other companies for 1958 and the

preceding four years in computing the adjusted reserves rate under Section 805(b). Regulations Section 1.805–5(a)(4) provides for the inclusion of such items in assets when computing the adjusted reserves rate. Exhibit 1 includes these amounts in assets in determining the adjusted reserves rate. This inclusion decreases the adjusted reserves rate from 3.32573% reported on claimant's 1958 tax return as filed, to 3.25846% (Schedule B, Part III, Line 7) in Exhibit 1.

Exhibit 1, as a result of correcting the above-described omissions and errors, shows that claimant's 1958 tax liability is $58,128.84, before making the adjustments provided in Sections 804(a)(6) and 809(b)(4).

Attached hereto are Exhibits 2 and 3 which are alternative computations of claimant's 1958 tax liability. These computations give effect to the adjustments provided for in Sections 804(a)(6) and 809(b)(4). When these computations are compared with that in Exhibit 1, they establish that the application of the definition of "taxable investment income" (Sections 804(a)(2)) and of the definition of "gain from operations" (Section 809(b)(1)), without adjustment, result in the imposition of tax on state and municipal bond interest accrued by claimant during 1958.

Exhibit 2 computes claimant's 1958 tax liability (after making the corrections and additions made in Exhibit 1) by excluding all state and municipal bond interests accrued in 1958 and the prior four years from gross investment income (Section 804(b), Schedule A, Line 1(a)). This results in computing claimant's 1958 "life insurance company taxable income" without taking into account any amount of tax exempt interest (as if it had not received any tax exempt interest in 1958 or in the prior four years) all other facts during these years remaining unchanged.

A comparative analysis of the tax computations under Exhibits 1 and 2 is attached. The comparison of the two exhibits shows that the direct result of excluding tax exempt interest from all items of the tax computation in Exhibit 2 is to reduce "taxable investment income" by $10,992.61 ($83,936.17 minus $72,943.56) and to reduce "gain from operations" by $32,928.36 ($160,790.13 minus $127,861.77). This results in Exhibit 2 showing a reduction in "life insurance company taxable income" of $21,960.49

($122,363.15 minus $100,402.66) which in turn reduces claimant's tax liability for 1958 from $58,128.84 in Exhibit 1 to $46,709.38 in Exhibit 2 by an amount of $11,419.46.

7 The attached comparison of Exhibits 1 and 2 demonstrates that the inclusion of tax exempt interest in the formulas which compute the percentage of net investment income, i.e., investment yield, included in the insurance company's income base under Sections 804(a)(2) (defining "taxable investment income") and 809(b)(1) (defining "gain from operations") directly increases the amount of investment yield included in income. Thus, the company's share of investment yield included in "taxable investment income" is decreased from 12.9312% in Exhibit 1 to 11.6263% in Exhibit 2 as a result of excluding all tax exempt interest. (See further Items 7 and 8 of comparative analysis.) Also, the attached comparison demonstrates that the exclusion of tax exempt interest in Exhibit 2 in computing "gain from operations" directly results in decreasing the company's share of investment yield from 10.1246% in Exhibit 1 to 6.2158% in Exhibit 2. (See further Items 14 and 15 of comparative analysis.)

Exhibit 3 computes claimant's 1958 tax liability by including the full amount of tax exempt interest in gross investment income as is done in Exhibit 1. Exhibit 3, Schedule C, deducts (rather than excludes) the policy and other contract liability requirements (Line 4, Schedule B, Part 1) from the investment yield (Line 14, Schedule A) to obtain the amount of investment yield included in taxable investment income. The resulting figure ($113,673.88) is the same as in Exhibit 1. Similarly, Exhibit 3, Schedule E, deducts (rather than excludes) the required interest (Line 5, Schedule E–1) from the investment yield (Line 4, Schedule A) to obtain the amount of investment yield included in gain from operations. Again, the resulting figure ($89,001.87) is the same as in Exhibit 1. Further, in Exhibit 3, the full amount of tax exempt interest accrued in 1958 is deducted; in Exhibit 1, only the company's share of tax exempt interest is deducted.

A comparative analysis of the tax computations under Exhibits 1 and 3 is attached. This comparison of Exhibits 1 and 3 shows that the effect of the adjustments in the tax computation in Exhibit 3 is to reduce "taxable investment income" by $31,900.08 ($83,936.17 minus $52,036.09) and to reduce "gain from operations" by $32,928.36 ($160,790.13 minus

$127,861.77). The amount of reduction in "taxable investment income" and "gain from operations" is exactly the amount of the difference between the deductions of tax exempt interest in Exhibit 1 (which deducts only the so-called company's share of tax exempt interest) and Exhibit 3 (which deducts all tax exempt interest). See further Items 11 and 18 of comparative analysis.

8 The attached comparison of Exhibits 1 and 3 further shows that the adjustments made to the "application of the definition of taxable investment income" and to the "application of the definition of gain from operations" in Exhibit 3 reduces 1958 "life insurance company taxable income" by $32,414.22 ($122,363.15 minus $89,948.93) which decreases claimant's 1958 tax liability by $16,855.40 ($58,128.84 minus $41,273.44).

Claimant reserves the right to submit further computations and to offer proof under Sections 804(a)(6) and 809(b)(4) to establish additionally that the application of the definition of "taxable investment income" in Section 804(a)(2) and of the definition of "gain from operations" in Section 809(b)(1) without adjustment results in the imposition of tax on state and municipal bond interests accrued in 1958. For example, the deduction allowed in Schedule E, Exhibit 1, for increase in reserves is directly contrary to the tax exemption concept laid down by the United States Supreme Court in National Life Insurance Company vs. United States, 277 U.S. 313, (1928). This results because Exhibit 1 requires that the deduction be reduced by the entire amount of the tax exempt interest excluded (i.e. the so-called policy holders' share). Specifically:

Total increase in reserves	$1,480,610.37
Minus "policyholders' share" (Line 8, Schedule E), includes policyholders' share of tax exempt interest	790,064.38
Amount of deduction for increase in reserves allowed	$690,545.99

To be in accord with the National Life decision, the calculation should deduct only the policyholders' share of "other items of investment yield." Specifically:

Total increase in reserves	$1,480,610.37
Minus "policyholders' share" (Line 7, Schedule E), does not include policyholders' share of tax exempt interest	757,136.02
Amount of deduction for increase in reserves allowed	$723,474.35

The resulting "gain from operations" is the same as in Exhibits 2 and 3. This demonstrates that the calculation of "gain from operations" as required by Exhibit 1 erroneously overstates the policyholders' "gain from operations" by $32,928.36, the amount of the so-called policyholders' share of tax exempt interest.

9 Moreover, as a further alternative claim, claimant contends that the computation of "life insurance company taxable income" for 1958 without adjustment results in imposing a tax on the state and municipal bond interest accrued by claimant during the year and is, therefore, in conflict with the constitutional principles affirmed by National Life Insurance Company vs. United States, 277 U.S. 313 (1928) and Missouri vs. Gehner, 281 U.S. 313 (1930). Therefore, in any event, an adjustment to the computation of claimant's 1958 "life insurance company taxable income" is necessary to prevent the imposition of an unconstitutional federal income tax.

[Three copies of exhibits 1 to 3, computations and alternative computations, and the comparative analysis of exhibits 1 and 2 and exhibits 1 and 3 have been filed.]

In United States District Court for the Northern District of Oklahoma

Amendment to Complaint—Filed June 29, 1962

Comes now the Plaintiff, and within the time prescribed by the Federal Rules of Civil Procedure, and amends its Complaint heretofore filed on May 28, 1962, by the inclusion therein and addition thereto of the following paragraph, designated as Paragraph XI, to-wit:

XI. Plaintiff further states that in determining the income tax liability of the Plaintiff for the calendar year 1958, the Defendant has imposed a tax upon all or part of interest accrued to Plaintiff in 1958 from state and local bond obligations, and that the Defendant, in the determination and application of said tax, has thereby imposed a tax on Plaintiff contrary to the Constitution and the laws of the United States.

Wherefore, Plaintiff prays judgment against the Defendant in the amount of $22,782.35, or such greater amount as may be due, together with interest as provided by law, and for its

costs, and for such further and other relief to which Plaintiff may be entitled.

DICKSON M. SAUNDERS,
of Doerner, Stuart, Moreland, Campbell & Saunders,
BYRON V. BOONE,
of Boone & Ellison,
THOMAS C. THOMPSON, Jr.,
of Bird and Thompson,
Attorneys for Plaintiff.

Filed June 29, 1962.

In United States District Court for the Northern District of Oklahoma

Answer—Filed July 26, 1962

10 The defendant, United States of America, by its attorney, John M. Imel, United States Attorney for the Northern District of Oklahoma, for its answer to the Complaint herein alleges as follows:

I. Admits the allegations contained in paragraph I of the Complaint.

II. Admits the allegations contained in paragraph II of the Complaint.

III. Admits the allegations contained in paragraph III of the Complaint, except denies that any amount of income taxes was illegally and erroneously assessed and collected from the plaintiff for the calendar year 1958.

IV. Admits the allegations contained in paragraph IV of the Complaint.

V. Admits the allegations contained in paragraph V of the Complaint, except alleges that the amounts stated therein were paid by the plaintiff on March 16, 1959 and September 15, 1959, respectively.

VI. Denies the allegations contained in paragraph VI of the Complaint, except admits that Exhibit A of the Complaint is a true copy of the claim for refund filed by the plaintiff on August 22, 1961, but denies all allegations set forth in the said claim for refund which are not otherwise admitted herein.

VII. Admits the allegations contained in paragraph VII of the Complaint.

VIII. Alleges that it is presently without knowledge or information sufficient to form a belief as to the truth of the

allegations contained in paragraph VIII of the Complaint, except denies that any adjustment to the plaintiff's federal income tax liability is required by the provision of Sections 804(a)(6) and 809(b)(4) of the Int rnal Revenue Code of 1954.

IX. Denies the allegations contained in paragraph IX of the Complaint.

X. Denies the allegations contained in paragraph X of the Complaint.

11 XI. Denies the allegations contained in paragraph XI of the Amended Complaint.

Wherefore, defendant prays that the Complaint and the Amended Complaint be dismissed with prejudice and that the defendant have its costs and disbursements.

UNITED STATES ATTORNEY.
By: L. K. SMITH,
Assistant U.S. Attorney.

In United States District Court for the Northern District of Oklahoma

Pre-Trial Order—Entered December 10, 1962

A pre-trial conference was held in the above cause on November 21, 1962, Dickson M. Saunders, Byron V. Boone and Thomas C. Thompson, Jr. appeared as counsel for the Plaintiff, and Sam E. Taylor, Assistant United States Attorney, Tulsa, Oklahoma, and George Hrdlicka, Department of Justice, Washington, D.C., appeared as counsel for the Defendant.

This is an action for the recovery of $22,782.35, together with interest as provided by law, or such greater amount as is by law refundable, brought by Plaintiff in connection with its claim for Federal income taxes that the Plaintiff alleges were erroneously and illegally assessed and collected for the year 1958 under the Life Insurance Company Income Tax Act of 1959.

Plaintiff contends that:

1. The application of the definition of taxable investment income (Sec. 804(a)(2) of the Internal Revenue Code of 1954) and the application of the definition of gain from operations (Sec. 809(b)(1) of the Internal Revenue Code of 1954) results in the imposition of a tax on all or a part of interest accrued in 1958 from state or local bond obligations owned by Plaintiff, which interest is excluded from gross income under Sec. 103 of the Internal Revenue Code of 1954, for:

(a) in determining its income tax liability for the calendar year, 1958, the Defendant has failed, neglected and refused to make the adjustments required by Sections 804(a)(6) and 809(b)(4) of the Internal Revenue Code of 1954 and a tax is thus imposed upon all or a part of interest accrued in 1958 from state or local bond obligations owned by Plaintiff, which interest is excluded from gross income under Section 103 of the Internal Revenue Code of 1954; and for

(b) in determining its income tax liability for the calendar year 1958, the Defendant has failed, neglected and refused to make the adjustments under Sections 804(a)(6) and 809(b)(4) of the Internal Revenue Code of 1954 and thus a tax has resulted on all or part of the interest accrued to Plaintiff in 1958 from state and local obligations, in violation of the principles set forth in National Life Insurance Company v. United States, 277 U.S. 313, (1928) and State of Missouri ex rel Missouri Insurance Company v. Gehner, 281 U.S. 313 (1930), which resulting tax is contrary to the Constitution and laws of the United States.

2. In determining the income tax liability of the Plaintiff for the calendar year 1958, the Defendant has imposed a tax upon all or part of interest accrued to Plaintiff in 1958 from state and local bond obligations, and that the Defendant, in the determination and application of said tax, has thereby imposed a tax on Plaintiff contrary to the Constitution and the laws of the United States.

Plaintiff claims that its evidence will establish:

1. That the application of the definition of taxable investment income (Sec. 804(a)(2) of the Internal Revenue Code of 1954) and the application of the definition of gain from operations (Sec. 809(b)(1) of the Internal Revenue Code of 1954) to Plaintiff result in the imposition of a tax on its interest from state and local bond obligations in that:

(a) The Life Insurance Income Tax Act of 1959, and the Treasury Regulations thereunder, adopt formulas dividing the investment yield of the Plaintiff between the policyholders and the Company, and because such formulas take into account exempt interest from the state and local bond obligations, the exclusions from Plaintiff's non-exempt income are automatically reduced.

(b) The exclusion of the policyholders' share of tax exempt interest does not prevent the imposition of a tax upon all

or a part of Plaintiff's interest from state and local bond obligations.

13 (c) The deduction of the Company's share of tax exempt interest does not prevent the imposition of a tax upon all or a part of Plaintiff's interest from state and local bond obligations.

(d) Solely because of the receipt or accrual of interest from state and local bond obligations the tax on Plaintiff's non-exempt income is automatically increased.

(e) The Defendant has failed to make or to permit adjustments as provided by Sec. 804(a)(6) and 809(b)(4) of the Internal Revenue Code of 1954.

2. The reserve requirements are liabilities of Plaintiff and are essential parts of the computation of Plaintiff's tax.

The Defendant contends that:

1. A tax has not been imposed on income from state and local bond obligations.

2. The Life Insurance Income Tax Act of 1959, and the Treasury Regulations thereunder, adopted formulas allocating the investment yield of the Company between policyholders and the Company, and that such formulas properly may take into account interest from state and local bond obligations without imposing a tax on such interest.

3. The investment yield set aside for policyholders (reserve requirements) is not subject to any income tax because it is excluded from the Plaintiff's taxable investment income.

4. All income from state and local bond obligations allocated to the Company is fully deducted and, therefore, not taxed.

5. The Life Insurance Company Income Tax Act of 1959 is constitutional as applied by the Defendant to Plaintiff.

The following questions of law are involved:

1. Does the application of Plaintiff of the definition of taxable investment income (Sec. 804(a)(2) of the Internal Revenue Code of 1954) and the application to Plaintiff of the definition of gain from operations (Sec. 809(b)(1) of the Internal Revenue Code of 1954) impose a tax on its exempt interest from state and local bond obligations so as to require adjustment to be made as provided in Sec. 804(a)(6) and Sec. 809(b)(4) of the Internal Revenue Code of 1954 to prevent the imposition of such a tax?

14 2. Does the Life Insurance Company Income Tax Act of 1959 impose a greater tax on the Plaintiff's income from non-exempt sources solely because of the receipt or ac-

crual of exempt interest from state or local bond obligations, and, if so, was it within the constitutional power of Congress to impose such a tax?

Orders of the Court

1. The Annual Reports of Atlas Life Insurance Company for the years 1954, 1955, 1956, 1957 and 1958, as filed with the Insurance Department of the State of Oklahoma, may be offered and received in evidence without further identification.

2. The 1958 Federal income tax return of Plaintiff may be offered and received in evidence.

3. The 1958 Federal income tax return of Plaintiff, based upon the revised figures from the Revenue Agent's Report of September 4, 1962, as computed without application of Sections 804(a)(6) and 809(b)(4) of the Internal Revenue Code of 1954, subject to verification by Defendant of the correctness of the mechanical application of mathematics and arithmetic to such return based on the Revenue Agent's Report, may be offered and received in evidence. This revised 1958 tax return shows the agreed tax liability of the Plaintiff for that year except as may be modified by this Court's decision on the issues in this cause.

4. The bonds, assets, and all items of property set forth in the Annual Reports referred to in paragraph numbered 1 above will be considered as assets owned by Plaintiff, unless Defendant after examination by its agents thereof has proof to the contrary.

Witnesses and Exhibits of the Parties

1. Plaintiff will offer the following witnesses for oral testimony:

(a) Johnson D. Hill, Jr., Executive Vice President, Atlas Life Insurance Company, 415 South Boston, Tulsa, Oklahoma.

(b) Andrew Delaney, Senior Vice President, American General Life Insurance Company, Houston, Texas.

(c) A member of the staff of the office of Joe B. Hunt, Insurance Commissioner of the State of Oklahoma.

2. Plaintiff will offer the following exhibits:

(a) Items number 1, 2 and 3 of Orders of the Court.

(b) Additional tax computations and reconciliations for income received or accrued during the year 1958 in support of Plaintiff's contentions.

2. Defendant will furnish the names of its witnesses and the list of its exhibits within a reasonable time following the taking of depositions by Defendant of the three witnesses enumerated above on the part of Plaintiff.

Depositions

Plaintiff will have available the three witnesses enumerated above at 1218 Atlas Life Building, 415 South Boston Avenue, Tulsa, Oklahoma, on December 5, 1962 at 9:30 A.M. for the purposes of depositions.

Entered this 10th day of December, 1962.

LUTHER BOHANON, *Judge.*

Approved as to form:

DICKSON M. SAUNDERS,
Attorney for Plaintiff.
GEORGE HRDLICKA,
Attorney for Defendant.

Filed Dec. 12, 1962.

In United States District Court for the Northern District of Oklahoma

Before LUTHER BOHANON, United States District Judge.

Opinion—May 1, 1963

This case involves a claim for income tax refund for the year 1958. Atlas Life Insurance Company, a corporation, hereinafter referred to as Atlas or Taxpayer, filed this suit against the United States of America seeking a refund in the sum of $22,782.35, or such greater amount as may be due, for alleged over-assessment by the Government of income taxes for the year 1958. The claim for refund has been reduced to $12,692.93, not by the pleadings, but by the evidence offered on behalf of Atlas and by Atlas' final Brief filed with the Court.

Plaintiff filed its tax return for the year 1958 in due time and thereafter timely filed its claim for refund. No action having been taken by the Government within the time provided by law, 26 U.S.C.A. 7422(a), thereafter this action was filed, as required by 26 U.S.C.A. 6532(a).

Certain adjustments in the Atlas' return show it entitled to a refund of $1440.74. This amount is not in dispute.

759-329—64——2

The claim made here by Atlas involves the application and interpretation of the Internal Revenue Code of 1954, as amended by the Life Insurance Company Income Tax Act of 1959, 26 U.S.C.A. 801 et seq.

Atlas contends that by the application of the definition of "Taxable Investment Income" (Section 804(a)(2)) and of the application of the definition of "Gain From Operations" (Section 809(b)(1)) of the Act results in the imposition of a tax on tax-free interest from state and municipal bonds owned by Atlas, which interest income should be excluded from its gross income under Section 103 of the Internal Revenue Code of 1954, 26 U.S.C.A. 103; Atlas claims that the Government refused to make adjustments required by Sections 804(a)(6) and 809(b)(4), thus imposing a tax on tax-exempt interest which is excluded from gross income under Section 103, supra.

By the Internal Revenue Code of 1954, as amended by the Life Insurance Company Act of 1959, hereinafter called the Act, Congress provided a method of taxing life insurance companies, taking into consideration interest which is not to be included in gross income under Section 103. This interest is one of several factors to be employed in determining the amount of the Taxpayer's taxable income. We are here concerned only with two phases of the various steps involved in arriving at taxable income; that is, (1) taxable investment income, and (2) gain from operations.

Considering the first, "taxable investment income": The Act, Section 804(a) (1) and (2) provides:

17 (a) In general.—

(1) Exclusion of policyholders' share of investment yield.—The policyholders' share of each and every item of investment yield (including tax-exempt interest, partially tax-exempt interest, and dividends received) of any life insurance company shall not be included in taxable investment income. For purposes of the preceding sentence, the policyholders' share of any item shall be that percentage obtained by dividing the policy and other contract liability requirements by the investment yield; except that if the policy and other contract liability requirements exceed the investment yield, then the policyholders' share of any item shall be 100 percent.

(2) Taxable investment income defined.—For purposes of this part, the taxable investment income for any taxable year shall be an amount (not less than zero) equal to the amount

(if any) by which the net long-term capital gain exceeds the net short-term capital loss plus the sum of the life insurance company's share of each and every item of investment yield (including tax-exempt interest, partially tax-exempt interest, and dividends received), reduced by—

(A) the sum of—

(i) the life insurance company's share of interest which under section 103 is excluded from gross income.

(ii) the deduction for partially tax-exempt interest provided by section 242 (as modified by paragraph (3)), computed with respect to the life insurance company's share of such interest, * * *

Section 804(a)(6) provides:

Exception.—If it is established in any case that the application of the definition of taxable investment income contained in paragraph (2) results in the imposition of tax on—

(A) any interest which under section 103 is excluded from gross income,

(B) any amount of interest which under section 242 (as modified by paragraph (3)) is allowable as a deduction, * * * adjustment shall be made to the extent necessary to prevent such imposition.

18 The pertinent section of the Act relating to gains from operations, Section 809(b), provides:

(b) Gain and loss from operations.—

(1) Gain from operations defined.—For purposes of this part, the term "gain from operations" means the amount by which the sum of the following exceeds the deductions provided by subsection (d):

(A) the life insurance company's share of each and every item of investment yield (including tax-exempt interest, partially tax-exempt interest, and dividends received);

(B) the amount (if any) by which the net long-term capital gain exceeds the net short-term capital loss; and

(C) the sum of the items referred to in subsection (c).

(2) Loss from operations defined.—For purposes of this part, the term "loss from operations" means the amount by which the sum of the deductions provided by subsection (d) exceeds the sum of—

(A) the life insurance company's share of each and every item of investment yield (including tax-exempt interest, partially tax-exempt interest, and dividends received);

(B) the amount (if any) by which the net long-term capital gain exceeds the net short-term capital loss; and

(C) the sum of the items referred to in subsection (c).

(3) Life Insurance company's share.—For purposes of this subpart, the life insurance company's share of any item shall be that percentage which, when added to the percentage obtained under the second sentence of subsection (a)(1), equals 100 percent.

Section 809(b)(4) provides:

(4) Exception.—If it is established in any case that the application of the definition of gain from operations contained in paragraph (1) results in the imposition of tax on—

(A) any interest which under section 103 is excluded from gross income.

(B) any amount of interest which under section 242 (as modified by section 804(a)(3) is allowable as a deduction, * * * adjustment shall be made to the extent necessary to prevent such imposition.

There is no dispute about the facts. A question of law only is presented here which can be resolved by an examination of the testimony, briefs, and especially the Taxpayer's return and the definition of "taxable investment income" and "gains from operations" as defined by the Act, supra.

Determination of taxable investment income and gain from operations is determined as follows: Taxable investment income: from gross investment income, Section 804(b), which includes tax-exempt interest, less certain deductions, Section 804(c)(1), resulting in a figure known as "investment yield," Section 804(c). This yield is then divided into two parts, (1) the policyholders' share, (2) the company's share. This division is made by the use of a percentage determined as provided by Section 805 of the Act. The entire part belonging to the policyholders as determined by the formula, including tax-exempt interest, is excluded from taxable income, Section 804(a)(1). The company's portion of each item of investment yield is then reduced by its portion of tax-exempt interest and other specified deductions, Section 804(a)(2). The resulting figure is the company's tax base for "taxable investment income," the first phase upon which the tax is imposed. Tax-exempt interest on the company's share of investment income, as can be seen, is wholly excluded in arriving at the final figure representing taxable investment income.

Turning to the second phase, gain from operations: Entering into the Taxpayer's taxable income is included the company's share of each item of investment yield, including tax-exempt interest, long-term capital gain, and other items includible in gross income under Section 61, Internal Revenue Code of 1954 (26 U.S.C. 958 edition, Section 61) not otherwise included: Sections 809(b)(1) and 809(c). This amount is reduced by certain deductions, including the company's share of tax-exempt interest (809(d)(8)). Tax-exempt interest with respect to gain from operations is treated exactly in the same manner as such interest is treated in determining taxable investment income. The problem involved here is the application of the formula for treatment of tax-exempt interest with respect to taxable investment income and gain from operations. By use of the formula provided by Section 804(a)(2) and Section 809(b)(1) the percentage of the policyholders' share of income in this case is less than it would be if tax-exempt interest was not included or considered in gross income for the purpose of the computation as provided by Section 804, supra, thereby leaving a greater portion as the company's share, resulting in a greater tax liability.

Atlas' Exhibit 6, being its return filed in compliance with the Act and regulations of the Internal Revenue Service, shows the policyholders' share of investment income is 85.33% plus, and the company's share 14.66% plus, and the policyholders' share of gain from operations 87.93% plus, and the company's share 12.66% plus. Atlas' Exhibit 7, being a tax form prepared by it in line with its theory of the law, excludes from any consideration all tax-exempt interest, and shows the policyholders' share of investment income as 86.64% plus, and the company's share 13.39% plus, and gain from operations 91.12% plus and 8.87% plus, respectively, reducing the amount of the company's income and thus its tax. The Taxpayer contends that under Section 804(a)(6) and 809(b)(4), the exception provisions of the Act, the application of the formula used by the Government results in a tax on its non-taxable interest income and therefore an adjustment should be made to prevent such tax. Under the formula used by the Government and as provided by the Act, company's tax-exempt interest is included in gross income and then deducted before reaching the tax base of the Taxpayer. The Taxpayer's formula excludes tax-exempt interest from the beginning. The inclusion or exclusion of tax-

exempt interest results in the difference between the tax imposed and the claimed refund.

Atlas contends that the formula for determining its income tax is unconstitutional in that a tax is laid upon its tax-exempt interest income. I do not agree. The Act simply classifies income for purposes of taxation and no tax is laid upon tax-exempt interest received by Atlas. The Power of Congress to lay and collect taxes is plenary subject only to certain constitutional restrictions not here present. The Congress may classify incomes for the purpose of taxation. The formula provided by Congress is for all similar life insurance companies and does not discriminate against any, including Atlas.

21 To adopt the formula urged by Atlas would amount to a striking down of the formula adopted by Congress, which this Court will not approve, and at the same time set up a formula not provided by Congress. In the Atlas formula it gives no consideration to interest from tax-exempt securities as income. This is certainly unrealistic. For the power of Congress to classify income and lay a tax thereon see Denman vs. Slayton, 282 U.S. 514. In this case the Taxpayer was engaged in buying and selling tax-exempt municipal bonds. In 1922 he collected $65,720.06 as interest on these securities and paid out $78,153.84 for interest on money borrowed in due course to purchase and carry exempt securities. In his tax return he excluded the interest so collected and claimed a deduction for interest paid out on borrowed money. The Tax Commissioner disallowed the deduction. The Court said:

"Determination of the question involved must turn upon the validity, construction and effect of Sections 213 and 214, Revenue Act of 1921, 42 Stat. 227, 237, 238, 239. Their pertinent provisions follow.

'Sec. 213. That for the purposes of this title * * * the term "gross income"— * * *

'(b) Does not include the following items, which shall be exempt from taxation under this title: * * *

'(4) Interest upon (a) the obligations of a State, Territory, or any political subdivision thereof, or the District of Columbia; * * *

'Sec. 214. (a) That in computing net income there shall be allowed as deductions: * * *

'(2) All interest paid or accrued within the taxable year on indebtedness, except on indebtedness incurred or continued

to purchase or carry obligations or securities (other than obligations of the United States issued after September 24, 1917, and originally subscribed for by the taxpayer) the interest upon which is wholly exempt from taxation under this title; * * *' "

The taxpayer in Denman vs. Slayton, supra, contended that the exception found in paragraph (2), Section 214(a) conflicts with the Federal constitution in that by necessary operation it discriminates against owners of non-taxable securities; also that the Act is discriminatory and unconstitutional in
22 that necessary expenses incident to all kinds of businesses, including interest paid for carrying inventories, et cetera, are allowed as operation costs, whereas deduction of interest paid by the taxpayer upon funds borrowed to carry non-taxable securities is prohibited. Taxpayer further contended that the Act is arbitrary and unconstitutional for it discriminates against him whose resources do not permit him to purchase tax-free securities for cash. The Court then said, Page 519:

"While guaranteed exemptions must be strictly observed, this obligation is not inconsistent with reasonable classification designed to subject all to the payment of their just share of a burden fairly imposed. * * * The classification complained of is not arbitrary, makes no improper discrimination, does not result in defeating any guaranteed exemption, and was within the power of Congress. The fact that respondent engaged in the business of buying and selling is not important."

The exception provisions of the Act, 804(a)(6) and 809 (b)(4) were enacted by Congress to make doubly sure that tax-exempt interest would not in fact be taxed and that if by some misapplication of the formula or mathematical error it is taxed, then by application of these provisions an adjustment would be made.

Atlas relies heavily on National Life Insurance Company vs. United States, 277 U.S. 508, and State of Missouri, ex rel Missouri Insurance Company vs. Gehner, 281 U.S. 313. These cases do not support the Taxpayer's position. In National Life the Court held as unconstitutional Section 245(a) of the Revenue Act of 1921, 42 Stat. 227, which provided that a reserve deduction allowed to all insurance companies should be reduced by the amount of tax-exempt interest received. The Court in essence held that by pro tanto denying a deduction solely by reason of receipt of tax-exempt interest, the

Congress had imposed a tax on that interest which was constitutionally exempt. In Missouri vs. Gehner, the Court held unconstitutional a state property tax on net worth of insurance companies which, in computing net worth, allowed a deduction for federal bonds, but required a pro rata deduction in the deduction that was otherwise allowable for insurance reserves. No comparable denial of deductions is made by the Act here in question. These cases cannot be so narrowly construed as urged by Atlas. See Denman vs. Slayton, supra.

Having reached the conclusion that by the application of the Act, tax-exempt interest received by Atlas is not in fact taxed, judgment will be entered denying the claimed refund, except to the extent of $1,440.74 resulting from adjustments agreed upon by the parties.

Dated this 1 day of May, 1963.

LUTHER BOHANON,
United States District Judge.

23 In United States District Court for the Northern District of Oklahoma

Judgment—May 1, 1963

Based upon the Opinion of the Court filed this date,

It Is Ordered, Adjudged And Decreed by the Court that plaintiff's claim for refund in the sum of $1,440.74, with interest, should be allowed.

It Is Further Ordered that the remaining claim for refund of the plaintiff should be denied.

Judgment Is Entered Accordingly.

Dated this 1st day of May, 1963.

LUTHER BOHANON,
United States District Judge.

In United States District Court for the Northern District of Oklahoma

Notice of Appeal—Filed June 21, 1963

Notice is hereby given that Atlas Life Insurance Company, a corporation, Appellant herein, hereby appeals to the United States Court of Appeals for the Tenth Circuit from the Judgment entered in this action by the United States District Court for the Northern District of Oklahoma on the 1st day of May,

1963, insofar as said Judgment denies the remaining claim for refund of Plaintiff therein, Appellant herein designated, over and above the sum allowed to Plaintiff in the amount of $1,440.74, with interest, and the United States of America is hereby designated Appellee.

DICKSON M. SAUNDERS,
of Doerner, Stuart, Moreland, Campbell & Saunders,
BYRON V. BOONE,
of Boone & Ellison,
THOMAS C. THOMPSON, Jr.,
of Bird and Thompson,
Attorneys for Appellant.

24 [An appeal bond was filed June 21, 1963.]

In United States District Court for the Northern District of Oklahoma

Statement of Points—Filed July 9, 1963

The points upon which Appellant intends to rely in this Appeal are as follows:

1. The Trial Court erred in failing to determine that Plaintiff had overpaid its Federal Income Taxes for the year 1958 in the amount of $12,692.93, and to grant a refund thereof.

2. The Trial Court erred in failing to determine the question of fact and of law that Defendant's application of the Life Insurance Company Income Tax Act of 1959 to Plaintiff in respect of the year 1958 resulted in the imposition of Federal Income Tax on interest on state and other local governmental obligations, which interest is excluded from gross income under Section 103 of the Internal Revenue Code.

3. The Trial Court erred in failing to determine the question of fact and of law that Defendant's application of the definition of "'taxable investment income" in Section 804(a)(2) of the Internal Revenue Code and "gains from operations" in Section 809(b)(1) of the Internal Revenue Code to Plaintiff in respect of the year 1958 resulted in the imposition of Federal Income Tax on interest excluded from gross income under Section 103 of the Internal Revenue Code.

4. The Trial Court erred in failing to determine that it was necessary pursuant to the provisions of Section 804(a)(6) and

Section 809(b)(4) of the Internal Revenue Code to adjust Defendant's determination of Plaintiff's income tax liability for the year 1958 to prevent the imposition of Federal Income Tax on interest excluded from gross income under Section 103 of the Internal Revenue Code.

5. The Trial Court erred in failing to determine that Defendant's application of the Life Insurance Company Income Tax Act of 1959 to Plaintiff in respect of the year 1958 was contrary to the intent of Congress in enacting such Act and violated the Constitution of the United States.

Dated this 9th day of July, 1963.

DICKSON M. SAUNDERS,
of Doerner, Stuart, Moreland, Campbell & Saunders,
BYRON V. BOONE,
of Boone & Ellison,
THOMAS C. THOMPSON, Jr.,
of Bird and Thompson,
Attorneys for Appellant.

25 [By order of July 24, 1963, the time for docketing the cause in the Court of Appeals was extended to August 15, 1963.]

In United States District Court for the Northern District of Oklahoma

Excerpts From Transcript of Trial Proceedings
Tulsa, Oklahoma, December 27, 1962

Appearances: For the Plaintiff: Doerner, Stuart, Moreland, Campbell & Saunders, (by) Dickson M. Saunders, Boone & Ellison, (by) Byron Boone, Bird & Thompson. For the Defendant: George Hrdlicka, Department of Justice, Washington, D.C., Sam E. Taylor, Assistant United States Attorney, Northern District of Oklahoma.

The COURT. The case on the trial docket this morning is Atlas Life Insurance Company vs. United States of America. Is the plaintiff ready?

Mr. SAUNDERS. Plaintiff is ready, your Honor.

The COURT. Defendant ready?

Mr. HRDLICKA. Defendant is ready, your Honor.

The COURT. Very well. The rest of the docket will be called later in the day.

Mr. BOONE. If the Court please, in this case I believe Government counsel at the pretrial mentioned something about the importance of the case to the Government. It is just equally as important to the taxpayers of the country; and we have with us this morning a representative of the City of Tulsa and also a Mr. Zarra who represents the New York Port Authority. They would like to sit in this case and with your Honor's permission file an amicus curiae brief later, and with your permission I think they would like to make a short statement along with ours when the case starts or proceeds, if that is satisfactory with your Honor.

The COURT. Very satisfactory indeed. The parties are indeed welcome to this court. Thank you, Mr. Boone.

26 JOHNSON D. HILL, JR., called as a witness on behalf of the plaintiff, being of lawful age and having first been duly sworn, testified as follows:

Direct Examination by Mr. SAUNDERS:

Q. State your name. A. Johnson D. Hill, Jr.

Q. Where do you live, Mr. Hill? A. Tulsa, Oklahoma.

Q. What is your occupation?

A. I am Executive Vice President and Assistant Treasurer of the Atlas Life Insurance Company.

Q. That's the plaintiff in this case? A. That's correct.

Q. How long have you held that position? A. Six years.

Q. What are your duties with the plaintiff as Executive Vice President and Assistant Treasurer?

A. My duties are of a general supervisory nature over the operations of the company. In the absence of senior officers I function in their stead.

Q. Do you have any duties with relation to Atlas insofar as investments are concerned?

A. I participate in the management decisions with respect to investments, yes.

Q. Are you a member of the Investment Committee? A. I am.

Q. Could you please tell us, Mr. Hill, the policies and procedures followed by the Atlas Life Insurance Company in making investments?

A. Atlas Life invests in farm and urban residential first mortgage loans and in securities.

We invest with respect to securities largely in bonds. We look for as high a yield as we can obtain commensurate with the quality of the bond. The term of the bond and the maturity have a bearing also.

Q. When you speak of seeking a yield, a high yield commensurate with the other safety factors, do you and the other members of the Investment Committee give consideration to federal income taxes?

A. We do. We are concerned primarily with a yield after federal taxes.

Q. Are the investments of Atlas Life Insurance Company regulated by Oklahoma law? A. No, they are not. There are some restrictions in the Oklahoma law with respect to the proportion of certain types of investments to total assets. Other states have similar restrictions but as far as regulation, there is no state regulation.

Q. Mr. Hill, do you know what are life insurance reserves?

A. Yes. Life insurance—you mean reserves on life insurance contracts?

27 Q. Yes, sir.

A. Reserves are calculations of the future liabilities under outstanding policy contracts. The methods by which those reserves are calculated are primarily in the realm of our Actuarial Department. Generally they involve the use of mortality tables, certain interest assumptions, and valuation methods.

* * * * * *

The COURT. What are all of them? Let's just admit them all at one time. What are the exhibits?

Mr. SAUNDERS. Exhibit No. 1 is the annual statement of Atlas Life Insurance Company for the year 1958; Exhibit No. 2 is the annual statement for the company for 1957; Exhibit No. 3 is the annual statement for the year 1956; Exhibit No. 4 is the annual statement for 1955; Exhibit No. 5 is the annual statement for 1954; Exhibit No. 6 is computation of the 1958 income tax liability for Atlas Life Insurance Company, reflecting the adjusted figures as a result of the Revenue Agent's report. It's not the original return. It has been agreed upon with counsel for the defendant that this copy may be introduced.

28 Exhibits 7 through 16 thereafter, your Honor, are alternate tax computations based on the particular tax

return for 1958. Exhibit No. 7 as being the subsidiary to Exhibit No. 6 is likewise the 1958 tax return of Atlas Life Insurance Company, adjusted however to exclude all items of tax exempt income.

* * * * *

Exhibit 9 is a computation based on the 1958 tax return showing, however, the effect of an increase of $1000 of additional income within the category of wholly taxable investment income.

Exhibit 10 likewise is based on the 1958 tax return but to show the receipt of an additional $1000 of tax exempt income for interest from state and local bond obligations.

* * * * *

29–30 Q. (By Mr. SAUNDERS.) Does Atlas Life Insurance Company, and in particular you on the Investment Committee, take into account these life insurance reserves you spoke of a moment ago in making company investments? A. No, we do not.

Q. Do the reserves for life insurance contracts you mentioned a moment ago have any relation to your current investments or investment returns? A. No.

Q. Who makes the computations of the reserves, Mr. Hill?

A. Our Actuarial Department.

Q. Is there any requirement that the Actuarial Department make its computations pursuant to any state law?

A. The state has laws as to minimum reserve requirements and our procedures are in conformity with that, those regulations and laws.

Q. If there is no relationship between your investments and your reserves, what is the purpose of establishing the life insurance contract reserves?

A. The purpose of the reserves is to in a sense guarantee the non-forfeiture of values in the contract and to assure that the future liabilities under our various outstanding contracts will be met.

Q. Are the reserves assets of the company?

A. They are not. They are liabilities of the company.

Q. When you make an investment on behalf of Atlas Life Insurance Company, do you earmark that investment for any particular purpose? A. No.

Q. Are the increases and decreases in reserves reflected on the books of Atlas Life Insurance Company?

A. They are not reflected on the books, Mr. Saunders, if you mean by books ledger accounts and so on. Records are kept, of course, of the reserves and the totals for each class of outstanding contracts is calculated and the aggregate total is calculated once a year, but there are no ledger or journal entries with respect to reserves.

Q. In the actuarial computation of the reserves, is there an assumed rate of interest taken into consideration? A. There is.

Q. Now on the other side of the company management, when making an investment, is this assumed rate of interest taken into consideration? A. No, no, I would say it is not.

Q. Is there any requirement under state law to obtain a certain rate of return on any investment that Atlas makes?

A. Not to my knowledge.

Mr. SAUNDERS. That's all.

31 Cross-Examination By Mr. HRDLICKA:

Q. Mr. Hill, I wanted to clarify one point. You made a statement that state law has no control over your investment policy. That's not entirely true, is it, sir?

A. I believe I qualified that by pointing out that there are restrictions as to the total volume of investments of certain types.

Q. So that the statutes do impose certain restrictions as to the amount of investment in certain types of securities and other general restrictions and limitations, is that true?

A. To an extent, sir.

Q. And your investment policy stays within this statutory requirements, I assume? A. It does.

Q. You mentioned an assumed rate of interest. What is the purpose of the assumed rate of interest?

A. I am not sure I understand your question, sir.

Q. You mentioned in your direct testimony that you have occasions to use or employ an assumed rate of interest as opposed to an actual rate of interest, to your investment earnings, I would assume.

Now what is the purpose of using, how do you use that assumed rate of interest?

A. My reference to interest assumption, sir, was in connection with reserves, not to investments.

Q. To what do you apply the interest assumption?

A. Well, it is part of the formula, along with the valuation method, which is used to calculate the reserves.

Q. So that——

A. (Interposing.) It's in a sense a discount of future premiums.

Q. I see, and the assumed interest then is used to increase reserves, is that correct, or to decrease if that should be appropriate under the formula?

A. I am not sure I follow you there, sir. You are getting into a field that's somewhat technical. I am not an actuary.

Q. Don't you have an assumed interest factor which is applied against certain assets and anticipates future earnings for the purpose of setting premiums; or is that beyond your knowledge, and I will withdraw it.

A. Would you ask the question again? I'm sorry.

Q. Don't you have an assumed interest rate which is applied to certain investment assets to obtain a future investment picture for the purpose of establishing your premiums on policies?

A. I would say no to that question.

Q. I believe you stated that you make no distinction between the type of investment for purposes of reserves, is that correct?

A. That is true.

32 Q. Is there any distinction made on money that you receive from your investments as to how that money should be used or as to where it should be applied? A. No, there is not.

Q. So that all money received by the company is treated exactly the same, is that correct, irrespective of the type of security? A. That is true.

Q. You also mentioned that the reserve is a liability. In what sense is it a liability?

A. It's an obligation of the company.

Q. I mean how is it carried as a liability? On the balance sheet is it carried as a liability?

A. In our statement it is—you are speaking now of policy reserves?

Q. Yes.

A. Policy reserves are included along with other reserves as to liabilities.

Q. What is the purpose for carrying this reserve as a liability in your annual statements and on your balance sheet?

A. What is the purpose of carrying it——?

Q. Why is it carried as a liability?

A. Because it is a liability.

Q. Could you explain this, what does it cover?

A. Well, if I understand your question correctly, it covers among other things the cash and loan values.

Q. What about the exposure to the company on policies issued? Does it have anything to do with that; does it have anything to do with the anticipated exposure to the company on insurance policies issued? A. Yes, it does.

Q. And so it also covers that item, is that correct?

A. That is true.

ANDREW DELANEY, called as a witness on behalf of the plaintiff, being of lawful age and having first been duly sworn, testified as follows:

Direct Examination By Mr. SAUNDERS:

Q. What is your name? A. Andrew Delaney.

Q. Where do you live, Mr. Delaney? A. At Houston, Texas.

Q. What is your occupation? A. Actuary.

Q. Are you a consulting actuary or are you employed on a regular basis? A. No, I am employed by several life insurance companies.

33 Q. Would you name them, please, and your capacities?

A. Yes. I am Senior Vice President and Director of the American General Life Insurance Company at Houston, Texas; Vice President and Actuary of the Knights Life Insurance Company of Wilmington, Delaware; Vice President and Actuary of the Hawaiian Life Insurance Company of Honolulu; Vice President and Actuary and Assistant Secretary of the Home State Life Insurance Company of Oklahoma City.

Q. Are you a member of any professional societies or organizations? A. I am a member, I am a Fellow of the Society of Actuaries.

Q. Are you a member of any industry committees?

A. Yes, I am a member of the Joint Advisory Committee on Interpretation of Company Federal Income Tax Law.

Q. And who makes up the joint committee you speak of?

A. This is a joint committee of the American Life Convention and the Life Insurance Association of America, which are trade organizations the members of which hold 95% of all the assets of life insurance companies.

Q. How long have you been an actuary? A. For sixteen years.

Q. What is your educational background in connection with your actuarial work?

A. I have an A.B. from Oberlin College in Ohio and a B.S. from New York University in New York City.

Q. What has been your business experience?

A. From 1946 to 1949, I served as mathematician with the Equitable Life Insurance Society of the United States, in New York City. From 1949 to 1954, I served as Assistant Actuary of the Union Central Life Insurance Company of Cincinnati, Ohio, and in 1954 I joined the American General.

Q. Now did you serve as actuary for those companies you mentioned? A. I served in the Actuarial Department of those companies.

Q. Can you tell us generally what function an actuary performs?

A. Yes. An actuary bears the principal responsibility for determining a company's premiums, for valuing its liabilities. In the case of a mutual company, for setting its dividends scale. He usually helps draft the policy forms and computes the nonforfeiture value in those policy forms. He advises the company management in connection with compliance with the nonforfeiture laws of the various states and in general he is the company officer to whom management looks for advice about mortality experience, assumed interest rates and lapse rates used in premium calculations.

Q. You mentioned earlier that you were a Fellow of the Society of Actuaries. Are there any requirements for achieving this status?

A. Yes, there are a series of eight examinations which are conducted by the Society of Actuaries, and after completion of the eight examinations, the designation of Fellow is awarded.

34 Q. Are you employed by Atlas Life Insurance Company? A. No.

Q. Have you ever performed any actuarial services for Atlas Life Insurance Company? A. No.

Q. Are you familiar with the books and records of Atlas Life Insurance Company?

A. Yes, I have examined the books and records of the company in its home office in Tulsa.

Q. Are you also familiar with the annual statements filed by Atlas Life Insurance Company in the office of the Oklahoma Insurance Commissioner? A. Yes.

Q. These have been identified as Exhibits 1 through 5 inclusive. Have you examined those? A. Yes.

Q. Do you know, Mr. Delaney, whether or not Atlas Life Insurance Company was audited for federal income tax purposes in 1958?

A. Yes.

Q. Have you examined the Revenue Agent's report on that audit?

A. Yes.

Q. In your capacity for these various companies by whom you have been employed and by whom you are employed at the present time, have you had occasion to prepare federal income tax returns?

A. Yes, I am responsible for the preparation in all of the companies for which I now work.

Q. And for how many years past have you been preparing income tax returns for life insurance companies? A. For about ten years.

Q. Have you prepared a 1958 income tax return for Atlas Life Insurance Company, based on the 1959 Life Insurance Company Income Tax Act? A. Yes.

Q. What materials did you use in the preparation of that?

A. Used the company's books and records, the 1958 annual statement and the annual statement for the four preceding years, and also the adjustments made by, made in the Revenue Agent's report.

Q. Have you made a number of alternate computations of tax based upon the figures reflected in that income tax return in the company books and records, the annual statement and the Revenue Agent's report? A. Yes.

Q. Before we go to these returns you have prepared, Mr. Delaney, can you tell us what are life insurance reserves?

A. Yes. Let me begin by defining the meaning of present value as used by an actuary. If a series of payments is to be made in the future, the value of that series of payments to a recipient is something less than the aggregate sum which you will receive because if you had that sum in hand now, you could earn interest on it and hence it would be worth more to him.

35 Let me illustrate that by saying, if you are to receive $1000 a year each year for ten years, the present value of that—the single sum which if you held it in your hand now would be equivalent to that series of payments—will of course depend upon the interest rate.

For example, at 6% interest, it is $7,360.09. The actuary would then say that $7,360.09 is the present value of that series of payments, discounted for interest. If a series of payments to be made in the future is also going to depend upon whether a particular individual is alive, the actuary would also take into account the probability that that individual might be dead in determining the present value, and he would then say the present value of that series of payments was discounted for interest and mortality.

Let me say that, with that background, that at the time of issue of any life insurance contract, the present value of net premiums contracted to be paid on that policy is exactly equal to the present value of the death benefits provided by the contract. The death benefits are of course the sum insured.

At any time after issue, however, the present value of the future net premiums is somewhat less because there are fewer future net premiums to be paid on the contract. At the same moment, present value of the future death benefits is somewhat greater because the probable date of death has drawn nearer.

The difference between the increased present value of these future death benefits and the decreased present value of the future net premiums constitutes the life insurance reserve.

Q. Is this an asset of the company?

A. No, this is a liability of the company.

Q. Are the reserves on each policy issued, by Atlas for instance, the same?

A. No, the reserves vary for each class of policy and by age at issue.

Q. Do you know how this particular company, Atlas, computes its reserve? A. Yes.

Q. Could you tell us, please?

A. Yes. Atlas has established reserve standards based on assumed interest rates, assumed mortality tables many years ago; and each year at the end of the year they take an inventory of their existing policies and apply to this inventory of policies in force the reserves based on these assumed mortality tables and interest rates, and total the reserves for each class

of policies. The total reserve for the company is the aggregate of the reserve for each class of policy.

36 Q. Did the reserves for Atlas Life Insurance Company increase in 1958? A. Yes.

Q. Why did the reserves increase?

A. The reserve increased because the application of the reserve factors to the year end inventory at December 31, 1958 was more than the application of the reserve factor to the inventory of policies in force at December 31, 1957.

Q. Did the earnings of Atlas Life Insurance Company, either reflected in the annual statement or in the federal income tax returns or in the books and records, have any bearing on the computation of those reserves?

A. None whatsoever. The reserves are based, as I said previously, on assumed interest rates and mortality tables.

Q. In 1958, Mr. Delaney, what would have been the situation if Atlas Life Insurance Company had earned more on its investments than shown on its federal income tax return with reference to its reserves?

A. Reserves would have increased exactly the same amount.

Q. Suppose, Mr. Delaney, for 1958 Atlas had not earned any return on its investments, would the reserves have increased or decreased?

A. They would have increased exactly the same amount because they have no relationship to the actual company earnings.

Q. Are the reserves for Atlas Life Insurance Company reflected by any funds? A. No, they are liabilities of the company.

Q. In your examination of the Atlas books and records in its home office and other data that you examined, have you found any segregation or earmarking of any assets? A. None whatsoever.

Q. Where on the books of Atlas are these reserves that you spoke of reflected?

A. They are not reflected on the company's books.

Q. Mr. Delaney, I hand you what has been marked for purposes of identification as Plaintiff's Exhibit No. 6 and ask you to state what it is.

A. This is the 1958 tax return of the Atlas Life prepared on the basis consistent with the Internal Revenue Service Regulations.

Q. Do you have a copy of that in your possession?

A. Yes, I do have.

Q. In this 1958 tax computation, on this particular form, are there any provisions to determine the application of the so-called exception clauses for tax exempt interest? A. No.

Q. What is the liability shown under that computation for 1958 federal income tax?

A. The liability for 1958 is shown on line 6 of page 1, and is $62,615.05.

37 Mr. SAUNDERS. If your Honor please, just so the record may be fully complete, I believe that Exhibit 6 has been received in evidence through stipulation with Government counsel.

Mr. HRDLICKA. That is correct.

The COURT. That is right.

Q. (By Mr. SAUNDERS). Can you tell us on this 1958 tax return how the amount of taxable investment income was computed?

A. Yes. The first step is to determine the company's investment yield. This is shown in Schedule A on line 14. Schedule A is on page 2 of the tax return. The company's investment yield is determined by including all items of investment income, including interest on state and municipal bonds and subtracting therefrom the investment expenses incurred in earning that investment income, and also subtracting certain other deductions permitted by the law.

Q. Does this return show the investment yield on line 14 in the amount?

A. Yes, the return shows that the investment yield for 1958 for the Atlas Life, on line 14, Schedule A, page 2, was $894,277.61.

Q. What is the next step necessary to be made in computing the company's taxable investment income for 1958?

A. The next step is to determine the policy and other contract liability requirements.

Q. Can you tell us generally what are policyholder and other contract liabilities?

A. Generally speaking, the policy and other contract liability requirements is that part of the increase in reserves assumed to come from interest earnings adjusted for the company's invested yield rate.

Q. Now that you have told us what this is, how do you compute the policyholder and other contract liability requirements?

A. The first step is to determine the company's earnings rate. These are determined by dividing the investment yield by the company assets. The calculation is contained on page 2, Schedule B, Part 3.

The next step is to adjust the company's life insurance reserves for the investment yield rate and this step is calculated on page 3 of the tax return in Schedule B, Part 5.

The next step is to multiply the company's investment yield rate by the adjusted life insurance reserves, and to add to this total the interest actually paid by the company. This step is contained on page 2 of the tax return, Schedule B, Part 1.

38 The total policy and other contract liability requirements is then for the Atlas Life in 1958 shown on page 2, Schedule B, Part 1, line 4, to be $763,144.28.

Q. Now is there a relation between the investment yield that you testified was on line 14 of Schedule A and this policyholder and other contract liability requirements?

A. Yes, the next step in the calculation is to determine the policyholders' share which is shown on page 3 of the return, Schedule C, line 1. This policyholders' share is equal to the policy and other contract liability requirements divided by the investment yield.

Q. What is that percentage?

A. That percentage for Atlas Life in 1958 is 85.33-plus percent, shown again on line 1 of Schedule C.

The next step is to determine the company's share, which is equal to 100 minus the policyholders' share. This is shown on line 2 of Schedule C to be 14.66-plus percent.

Q. Then what is the next step in computing its taxable investment income?

A. The next step in computing taxable investment income is to exclude from the investment yield the policyholders' share. This is done on lines 4, 5, 6 a[illegible] of Schedule C; and you will note by examining the tax return that there has been excluded $31,265.37 of tax exempt interest and $731,878.95 of other items of investment yield.

The resulting figure is shown on line 8, Column 3 of Schedule C, and is $131,133.29.

Q. Is that the tax base upon which the income tax liability is computed?

A. No, from this is deducted the company's share of the tax exempt interest shown on line 9 of Schedule C, and also the

small business deduction, line 12 of Schedule C, so that the taxable investment income is on line 14 of Schedule C, is $100,760.87.

Q. Mr. Delaney, in the literature surrounding the 1959 Life Insurance Company Income Tax Act, the hearings before both houses of Congress and otherwise, is this computation of taxable investment income what is known generally as the "Phase 1 tax"?

A. Yes, it is, and that, the figure on line 14 of Schedule C is carried over to the first page of the tax return and appears again in line 1–a on page 1 of the tax return.

Q. After completing the Phase 1 computation, what is the next step in determining income tax liability?

A. The next step is to calculate the gain from operations and the first step in this calculation is to determine the policyholders' share ratio for Schedule E, which appears on page 3–a of the tax return.

39 Q. Now this gain from operations that you are talking about, is that what is known generally in the literature and the hearings as the Phase 2 tax computation?

A. Yes, it is. That is known as Phase 2, and the gain from operations includes all items of income such as premiums and all other receipts, all items of investment income, and from this he deducted the death benefits, the increase in reserves and so forth.

Generally speaking, in the gain from operations follows page 4 of the company's annual statements, but there are some differences.

Q. What is the next step in connection with determining Phase 2, gain from operations income?

A. The step is to determine the policyholders' share. To do this we must first determine the company's required interest. This is calculated on page 4 of the tax return in Schedule E–1 and is equivalent to multiplying the reserves by the interest rate assumed in those reserves.

The figure for Atlas Life in 1958 appearing on line 5 of Schedule E–1, page 4, is $781,540.32.

Q. Mr. Delaney, is it true to state that this figure of $781,000-plus is computed from tabular tables of interest and assumptions?

A. Yes, the reserves are based on tabular interest assumptions and tabular mortality tables, and the required interest

figures depend only on these assumed interest rates and mortality tables.

Q. Would receipt of tax exemption be reflected in this Schedule E–1 of required interest?

A. No, since it is determined entirely from tabular items, the company's actual investment experience has no relationship to it.

Q. Then what is the next step?

A. Having determined the required interest, we divide the required interest by the investment yield, again from line 14 of Schedule A, and determine the policyholders' share which is shown on line 1 of Schedule E, page 3–a, and for Atlas Life in 1958 it's 87.39-plus percent.

The company's share is equal to 100 minus the policyholders' share, and this is shown on line 2 of Schedule E, and for Atlas Life it was 12.60-plus percent.

Q. Are there any further steps to be taken in computing the gain from operations?

A. Yes, the next step then is to exclude from the investment yield the policyholders' share. This is done on lines 4, 5, 6 and 7, Schedule E, and you will note that excluded in this computation was $32,019.04 of tax exempt interest and $749,521.28 of other items of investment yield.

Q. Then are other items of receipt and deduction taken into consideration in preparing the Phase 2 tax?

A. Yes. Then to the investment, taxable investment yield which appears on line 8 of Schedule E, we add all the company's receipts, premiums and so forth, and subtract from it the death benefits, the increase in reserve—the increase in reserve—excuse me, after reduction for investment yield as shown on line 14 of Schedule E, and we come back to the gain or loss from operations which appears on line 27 of Schedule E, and for the Atlas Life in 1958 it was $161,220.08.

Q. How do you use this figure then to compute the income tax liability for 1958?

A. The figure of $161,220.08 is then carried to line 1–b of page 1, and life insurance company taxable income is then determined to be the amount on line 1–a, which was the taxable investment income, plus 50 percent of the excess of the gain from operations over the taxable investment income. In the case of Atlas Life for 1958, the 50 percent amounted to $30,229.61, so that the total life insurance company taxable income,

which appears on page 1, line 3, was $130,990.48; and to that figure is applied the regular corporate income tax to determine the company's tax liability.

Q. Mr. Delaney, I hand you what has been marked for purposes of identification as Plaintiff's Exhibit No. 7 and ask you to tell us what it is.

A. This is a *calculation* of the 1958 tax return for Atlas Life computed exactly as the 1958 tax return, Exhibit 6, except that we have excluded from this tax return all items of investment yield.

Q. Yield? A. Tax exempt investment, excuse me.

Q. Do you have a copy of that? A. Yes, I do have.

Mr. SAUNDERS. Plaintiff now offers into evidence Plaintiff's Exhibit 7, the testimony by this expert witness.

Mr. HRDLICKA. Defendant objects on the ground that it is argumentative, irrelevant and immaterial.

The COURT. Overruled.

(Plaintiff's Exhibit 7 was received in evidence; see page 12.)

Q. (By Mr. SAUNDERS.) What is the amount of tax liability as shown on page 1 of Plaintiff's Exhibit 7?

A. The total tax liability is shown as $51,362.86.

Q. Did you make any assumptions in preparing this Exhibit 7?

41 A. Yes. As stated earlier, we omitted all the company's tax exempt investment income from our calculations. Thus on page 2, line 14 of Schedule A, the investment yield is in this case shown as $857,639.82, which is equal to the investment yield shown in the company's 1958 tax return less $36,637.79 of tax exempt interest.

Q. Is there a difference in this exhibit 7 and the tax return as filed with respect to the amount of policy and other contract liability requirements?

A. Yes, because of the change in, because of the omission of the tax exempt interest, the policy and other contract liability requirements shown in Schedule B, Part 1 in this exhibit, is $743,137.55 which is less than the policy and other contract liability requirements in the company's 1958 tax return.

Q. Can you explain this difference?

A. The difference occurs because the company's earnings rate are somewhat less in this exhibit, because we are dividing the investment yield, which is less because of the omission of the tax exempt interest, by the same assets and the reduction in

these earnings rates causes the decrease in the policy and other contract liability requirements. The difference in percentage is shown in Exhibit 2, Schedule—pardon me, in Exhibit 7, Schedule C. The liability requirements in this exhibit is divided by the investment yield. The policyholders share as shown on Schedule C, line 1 is 86.64-plus percent which is more than the policyholders' share in the company's 1958 tax return.

Q. Is there any *arithmetical* result of the higher policyholders' share percentage in this Exhibit 7 when you apply it to the balance of Schedule C?

A. Yes, the result is that other items of investment yield, as they emerge in Schedule C, are $114,502.27 which is roughly $11,000 less than the other items of investment yield as it merges in the Schedule C of the company's 1958 tax return.

Q. Is this as a result of the application of the different percentage found in Exhibit 7 as compared with the tax return?

A. Yes.

Q. Why is the percentage different, may I ask you?

A. The percentage is different solely because we excluded tax exempt interest in Exhibit 7 calculations.

Q. Drawing your attention to Schedule E of this Exhibit 7, which is the Phase 2 computation of gain from operations, can you explain the reason for a difference of the percentages of 91.12-plus percent for policyholders in this Exhibit 7, as opposed to 87.39-plus percent in the tax return?

A. Yes. The reason is that the required interest in our Exhibit 7 is identical with the required interest in the
42 company's tax return, because the required interest again depends only on tabular assumptions and the policyholders' share is equal to the required interest divided by the investment yield on Schedule A and we have reduced the investment yield in this exhibit by the exclusion of tax exempt interest.

Q. Applying that percentage which you have established in Exhibit 7 by excluding the receipt of the tax exempt income, applying that to the remainder of the formula for the Phase 2 computation for 1958, what is the result as compared with the gain from operations under Phase 2 under the tax return as filed?

A. The result is that in Schedule E in our Exhibit 7 we have included $76,099.50 which appears on line 7 of Schedule E, in Exhibit 7 calculations, as compared to $108,118.54 from line 7 of the company's 1958 tax return.

This difference is due solely to the fact that we have excluded tax exempt interest from our Exhibit 7 calculation and it results in a gain or a loss from operations in our exhibit, line 27, of $129,201.04 which is $32,019.04 less than the gain which appears in the 1958 tax return.

Q. And referring you, if you will, to Schedule E of the tax return, what was the amount of the policyholders' share of this gain from operations, excluded on line 4?

A. The amount excluded in the tax return was $32,019.04, which is exactly equal to the difference between the gain from operations in the 1958 tax return and in Exhibit 7.

Q. And you made no deduction in Exhibit 7, did you, on page 3-a, line 16, for wholly exempt interest?

A. No, because it was excluded entirely from the return.

Q. Is it fair to say that Exhibit 7 was prepared on the assumption that Atlas just didn't receive any interest from tax exempt bonds? A. Yes.

Q. Could it be on the same assumption that it had its amount of money represented by those tax exempt securities in an idle bank account? A. The result would have been exactly the same.

Q. Thank you. I hand you what has been marked for purposes of identification as Plaintiff's Exhibit 8, and ask you if you can tell us what it is, please?

A. Yes, I have a copy of it, and this is a calculation of the Atlas Life 1958 tax return as if it had not received $600.00 in interest, arising from Tulsa jail bonds.

Mr. SAUNDERS. Plaintiff offers Exhibit 8 into evidence.

43 Mr. HRDLICKA. Your Honor, I have the same objection which I previously stated. I would like to just make that a continuing objection for the record.

The COURT. You may do so and the record will so reflect, and the objection will be overruled.

(Plaintiff's Exhibit 8 was received in evidence; see page 12.)

Q. (By Mr. SAUNDERS.) Mr. Delaney, did the Atlas Life Insurance Company in 1958 have any Tulsa County jail bonds?

A. Yes, the Atlas Life owned $20,000 worth of Tulsa jail bonds on which it received $600.00 of interest in 1958.

Q. Was that $600.00 of interest in 1958 taken into account in the preparation of the tax return, Exhibit No. 6?

A. Yes, it was.

Q. I note in this Exhibit 8, which you now have before you, a number of inked notations. Can you tell us what those are, please?

A. Yes. The calculation in Exhibit 8 is made as if the Tulsa jail bonds had been in default and had paid no interest. The inked figures then show the changes which would have occurred in the company's tax return had this been the case.

You will note, for example, that on line 1—1–a of Schedule A—the inked figure is minus $600.00 which that is the change as the result of the fact that we have assumed the Atlas Life did not receive the $600.00 in tax exempt interest from these Tulsa jail bonds.

Q. And how is that reflected on page 1 as to the tax liability for 1958?

A. The tax liability shown on page 1 is $62,440.38 which is $175.00 less than the tax shown in the company's 1958 tax return.

Q. Did Atlas Life Insurance Company pay a tax of $175.00 in 1958 on the receipt of $600.00 interest from Tulsa County jail bonds?

A. Yes.

Mr. HRDLICKA. Your Honor, I am going to request that the last answer be excluded because it really constitutes a conclusion of law, because number one, the return under consideration was never filed. It's merely an exhibit. Number two, the witness' conclusion of what constitutes the imposition of tax is a question for the Court and not for the witness.

The COURT. Overruled.

44 Q. (By Mr. SAUNDERS.) Mr. Delaney, I hand you what have been marked for purposes of identification as Plaintiff's Exhibits 9 and 10. Can you tell me what they are?

A. Yes. These exhibits have been prepared to show the effect of including an extra $1000 of taxable investment income, that is exhibit that is marked as Exhibit 9, and Exhibit 10 shows the effect of including an extra $1000 of tax exempt interest.

Q. Do you have copies of those? A. Yes.

Mr. SAUNDERS. Plaintiff offers into evidence Plaintiffs Exhibits 9 and 10.

Mr. HRDLICKA. Same objection, your Honor.

The COURT. Haven't these been received in evidence before?

Mr. SAUNDERS. I was under the impression they had, your Honor, until just before the testimony of Mr. Delaney began.

The Government entered an objection to the relevancy and competency thereof and I felt it was appropriate to offer them again.

The COURT. They will be received in evidence.

(Plaintiff's Exhibits 9 and 10 were received in evidence; see page 12.)

The COURT. With the defendant's objection noted.

Q. (By Mr. SAUNDERS.) Can you explain to us the meaning of a marginal tax rate or marginal tax concept?

A. Yes. The marginal tax rate is the tax which would be paid on an additional $1.00 of income. Perhaps the clearest way to illustrate it would be to take the situation of an individual who earns $10,000 a year and we will say pays $1000 in income tax. The rate of tax is then 10%.

But if that individual were to earn an additional $1000 of income, his tax we will say would be increased to $1250 and thus on the additional $1000 of income he would have paid an additional $250.00 of tax, and we would say that his marginal tax rate is 25%.

Q. When identifying Plaintiff's Exhibit 9, you stated that you have prepared it to reflect the receipt of an additional $1000 of taxable investment income, and I note that on page 2 of the schedule of investment features of the company, some eight notations.

Is that to reflect $1000 additional taxable income?

45 A. Yes. In Exhibit 9 we have assumed that the company earned an additional $1000 income and this is shown by the ink figure on line, well, in the total figure for line 1, and on line 1–e of Schedule A.

Q. Then do the other inked figures on Plaintiff's Exhibit 9 reflect the result of this inclusion through the action of the formulas that you earlier went into detail concerning in the tax return?

A. Yes. The only change that is made in the company's 1958 tax return is to assume that we earned an additional $1000 and the inked figures in this Exhibit 9 show the changes which take place purely as the result of the mathematical calculations in their return.

Q. On Plaintiff's Exhibit 9, is there an increased tax liability reflected?

A. Yes, the line 6 of page 1 of this tax return, Exhibit 9, shows an increase in tax of $362.00 resulting from this increased

$1000 of income, and thus we would say that the marginal tax rate for Atlas Life was 36.2% on taxable investment income.

Q. Directing your attention to Plaintiff's Exhibit 10, I believe you identified same as saying it was prepared on the assumption that Atlas had received in 1958 an additional $1000 of tax exempt income. Do the ink figures on Plaintiff's Exhibit 10 reflect that in the appropriate schedules and do the ink figures also reflect the action of the formulas that you identified in detail in the tax return? A. Yes, they do.

Q. Did you make any other changes other than the inclusion of the $1000 wholly tax exempt income?

A. That was the only change that was made.

Q. What happened to the tax liability shown on page 1 of the return, assuming an additional $1000 of tax exempt income?

A. The total tax liability of the Atlas Life increased $291.00 as a result of the assumed $1000 increase in tax exempt investment income, and thus we would say that the Atlas Life has a marginal rate of 29.1% on tax exempt investment income.

Q. Have you ever served in an investment capacity in any of the companies by whom you are employed?

A. Yes, I served on the Investment Committee of the American General Life and on the Investment Committee of the Home State Life.

Q. As a member of the Investment Committee of these companies, can you tell us the objectives of those companies with reference to investments?

A. Yes. The objection of the committee is to secure the highest possible yield commensurate with the safety, liquidity and maturity.

Q. How do you determine the highest possible yield? You take into consideration any tax imposition?

46 A. Yes, we seek to secure the highest possible yield after federal income tax.

Q. How would you determine as a member of the Investment Committee whether to take cash and buy an interest paying security?

A. We would first determine the company's marginal tax rate and in effect we would prepare a pro forma tax return exactly as I have done in Exhibits 9 and 10.

Q. And from that could you tell the tax on the next additional dollar earned, in other words?

A. Yes, that would be the purpose of preparing that tax return.

Q. Now if two bonds are presented to an Investment Committee and you were serving on the Investment Committee, both of which constitute legal investments for life insurance companies and are identical as to call provisions, maturity and other factors, which bond would you select?

A. We would choose that bond that provided the highest after tax yield.

Q. Now using Plaintiff's Exhibit 9 which you state has a marginal tax rate for wholly taxable income of 36.2%, what would be the yield to the company on a 5% corporate rate security?

A. The net after tax yield to the company of a 5% corporate security purchased at par would be 3.19%, since the marginal tax rate is 36.2%.

Q. At what stated interest rate would Atlas, using the marginal rate concept of Plaintiff's Exhibit 10, have to purchase a municipal bond in order to have an equal yield?

A. Since the marginal tax rate shown in Exhibit 10 is 29.1% on tax exempt investment income, Atlas would need to secure a 4.5% yield on a tax exempt bond to have the equivalent after tax yield.

Q. In your experience as an investment officer, is it your judgment that an insurance company would be able to buy a state or local bond yielding 4.5% of the same grade as an industrial bond yielding 5%.

A. No, under normal market conditions the spread would be greater than that and the company if it chose to buy the municipal bond would have to select a lower grade bond. More likely it would buy the corporate obligation.

Q. Mr. Delaney, I hand you what has been marked for purposes of identification as Plaintiff's Exhibit 11 and Plaintiff's Exhibit 12. Can you tell us what those are? A. Yes, I have copies of these.

Exhibit 11 is a computation of the Atlas Life 1958 income tax based upon the 1942 law in which we have included all of the company's tax exempt investment income.

47 Exhibit 12 is an identical calculation based on the 1942 law but in this case we have excluded all of the company's tax exempt income.

Mr. SAUNDERS. We offer into evidence Plaintiff's Exhibits 11 and 12.

Mr. HRDLICKA. Same objection, your Honor.

The Court: Objection overruled. Plaintiff's Exhibits 11 and 12 will be received in evidence.

(Plaintiff's Exhibits 11 and 12 were received in evidence; see page 12.)

Q. (By Mr. SAUNDERS). I believe you stated, Mr. Delaney, that you have been preparing life insurance company income tax returns for ten years? A. Yes.

Q. Has some of that period involved the application of the 1942 Act? A. Yes.

Q. And these computations that you have before you, as Plaintiff's Exhibits 11 and 12, were made for the Atlas figures, numbers, books and records for 1958 but applying the 1942 Act; is that true?

A. That is true, and using the Treasury decision, whose number I forget at the moment, but which establishes the secretary's ratio for 1958.

Q. Is there any difference in tax liability between Plaintiff's Exhibit 11 and Plaintiff's Exhibit 12?

A. No, the tax liability which occurs on line 5 of page 1 of both returns is identical and is equal to $56,906.36.

Q. As an expert and as having prepared these tax returns, do you have an opinion for the reason that the two computations, Plaintiff's Exhibit 11 being based upon the presence of tax exempt interest and the computations of Plaintiff's Exhibit 12 being based on the absolute exclusion or absence of tax exempt interest, ending up in the identical tax liability?

A. Yes, Exhibit 11 which includes the tax exempt interest in this calculation as provided by the 1942 law, the tax exempt interest is included but it is fully deductible as provided by law. Thus the end result is exactly the same as the calculation in Exhibit 12 where we omitted the tax exempt interest completely.

Q. Mr. Delaney I hand you what has heretofore been introduced and received into evidence as Plaintiff's Exhibit 1, the annual statement of Atlas Life Insurance Company for 1958, and ask you to turn to page 4 and tell us if that return reflects the company's net gains from operations?

48 A. Yes, line 33 at page 4 shows a net gain from operations for the company of $248,220.87.

Q. The tax return for the company heretofore introduced and received into evidence as Plaintiff's Exhibit 6 indicates a gain from operations, does it not?

A. Yes, and the gain from operations as shown by the tax return is $161,220.08.

Q. Now Mr. Delaney, we are talking about contrasting the annual statements and this tax return with reference only to the Phase 2 tax computation, is that correct? A. Yes.

Q. Why is the total in the annual statement on page 4, some $248,220.00, and the gain from operations for federal income tax purposes less, being $161,220.00?

A. The reason is that there are certain items which are deductible for annual statement purposes but are not deductible for federal income tax purposes. An example would be federal income tax.

There are other items which are deductible in the annual statement that are not deductible for federal income tax—I'm sorry, reverse that and say there are other items which are deductible in the federal income tax return but are not deductible in the annual statement.

An example of these items would be the small business deduction and the deduction for non-participating insurance.

Q. You stated that you had seen the Revenue Agent's report at the conclusion of the audit for 1958. Is there a reconciliation sheet in that audit which reflects the differences of inclusion or exclusion or deductibility or includability between the annual statement and the tax return as filed? A. Yes, there is.

Q. I hand you what has been marked for identification as Plaintiff's Exhibit 13 and ask you what it is?

A. This is a reconciliation between the net gains from operations in the annual statement and the gain from operations in the tax return.

Q. And this is the appropriate page from the Revenue Agent's report; is that true? A. Yes.

Mr. SAUNDERS. We offer into evidence Plaintiff's Exhibit 13.

The COURT. Plaintiff's Exhibit 13 will be received in evidence with the defendant's objections noted.

(Plaintiff's Exhibit 13 was received in evidence; see page 12.)

49 Q. (By Mr. SAUNDERS.) In this reconciliation statement, Plaintiff's Exhibit 13, Mr. Delaney, can you tell us what increases you made and what deductions you made?

A. Yes. I started from the net gain from operations in the

annual statement of $248,220.87 and added to this those items which are deductible for statement purposes but not deductible for federal income tax purposes, such as federal income tax itself. The total of these items was $184,133.76, and thus the total gain from operations to this point was $432,354.63.

Q. And that's shown on the left-hand column marked Annual Statement, is that true, on Exhibit 13? A. Yes.

Q. How does this increased amount in the annual statement relate to the gain from operations in the tax return for 1958?

A. From this increased amount again, it is necessary to deduct those items such as the small business deduction, which are deductible for tax purposes but not for annual statement purposes. The total of these items, excluding any deduction for tax exempt interest, was $266,515.80, bringing us to a gain for tax purposes before any adjustment for tax exempt interest of $165,838.83.

Q. Did you make any further computations covering this amount of $165,838?

A. Yes. From this amount I deducted the company's share of tax exempt interest and the resulting amount is $161,220.08, which is exactly equal to the gain from operations as it appears in the tax return.

Q. What is the dollar amount of the company's share of tax exempt interest that was deducted in this Plaintiff's Exhibit 13?

A. $4,618.75.

Q. Is that same amount reflected as a deduction in the tax return as filed in Schedule E?

A. Yes, as the company's share of tax exempt income.

Q. Other than this deduction of $4,618.75, did you make any other calculation or computation or treatment of the tax exempt interest? A. No.

Q. As an expert in preparation of life insurance company income tax returns under the 1959 Act, do you have any opinion as to why the tax that is incident, if any, with reference to the balance of tax exempt interest received by Atlas during 1958, in Schedule E of the tax return is known as the company's share, $32,019.04, what is the incidence if any with reference to that from this reconciliation?

A. Since the gain from operations from the annual statement includes all items of tax exempt interest and since we have been able to reconcile that back to the gain from operations as shown in the tax return by deducting only the company's share of tax

exempt interest. $4,618.75, I conclude that the tax return has included in its gain from operations the balance of the tax exempt investment income simply as a matter of arithmetic, and that balance was some $32,000.

50 Q. Now directing your attention to Plaintiff's Exhibit 7, heretofore received in evidence, can you take these reconciliation figures and make a computation with reference to the tax liability shown on Exhibit 7?

A. Yes. Beginning again with the figure of $165,838.83 which was the gain from operations before any adjustment for tax exempt interest, I deduct from that figure the full amount of the tax exempt interest which the company received, $36,637.39 and this gives me a figure of $129,201.04 which is exactly equal to the figures shown on Exhibit 7 as the company's gain from operations.

Q. As an expert, do you have an opinion as to why the reconciliation approach with reference to the Revenue Agent's summary sheet and the Plaintiff's Exhibit 7, after excluding all the tax exempt interest, is as the figure of $161,220 for the taxable gain as appears in the return, if that is what occurred?

A. Yes, both—because both in the reconciliation and in Exhibit 7 we have excluded tax exempt interest completely, has no effect.

Q. I hand you now, Mr. Delaney, what have been marked for purposes of identification as Plaintiff's Exhibits 14, 15 and 16 and ask you to tell us what they are?

A. I have copies of these. Exhibit 14 is a calculation of the 1958 tax return of the Atlas Life, including the company's tax exempt interest in determining the policy and other contract liability requirements but deducting 100% of such tax exempt interest in computing the taxable investment income, as well as deducting all of the policy and other contract liability requirements.

The calculation follows the form of the tax bill as originally passed by the House, H.R. 4245.

Q. Is that before or after what is known as the "Add Back Provision"?

A. Before the Add Back Provision which was provided by that House bill.

Q. Tell us what is Plaintiff's Exhibit 15.

A. Plaintiff's Exhibit 15 is exactly the same calculation as was made in 14 except that in this case we have provided for the "add back" which was called for by that bill.

Q. And what is Plaintiff's Exhibit 16?

A. Plaintiff's Exhibit 16 is again a calculation under the House Bill but this time we have excluded tax exempt interest in computing the policy and other contract liability requirements, and we have also excluded the add back.

51 Mr. SAUNDERS. Plaintiff offers into evidence Exhibits 14, 15 and 16.

Mr. HRDLICKA. Same objections, your Honor.

The COURT. The defendant's objection will be overruled. Plaintiff's Exhibits No. 14, 15 and 16 will be received in evidence.

(Plaintiff's Exhibits 14, 15 and 16 were received in evidence; see page 12.)

Q. (By Mr. SAUNDERS.) Directing your attention to Exhibit 14, Mr. Delaney, what is the tax liability shown for Atlas under this computation? A. Tax liability shown is $46,161.11.

Q. Please compare this Exhibit 14 with the tax return as filed, being Exhibit No. 6, as to type of investment yield, policyholder and other contract liability requirements and the computation of tax.

A. The investment yield in this Exhibit 14 is identical with the investment yield in the company's 1958 tax return as filed. The policy and other contract liability requirements are identical also with the policy and other contract liability requirements in the exhibit as filed.

Q. In the tax return as filed, is that true?

A. In the tax return as filed. Excuse me.

Q. In other words, both the tax return as filed and Exhibit 14 included the full amount of tax exempt interest received in 1958?

A. That's correct.

Q. Are there any changes in the computation of the tax under Schedule C between this exhibit and the tax return as filed?

A. Yes. Schedule C in this exhibit deducts the full amount of tax exempt interest, $36,637.79, while the 1958 tax return deducts only the company's share of such tax exempt interest.

The same thing is true in Exhibit E—in Schedule E, excuse me, in Schedule E where again we have deducted the full amount of tax exempt interest, where the tax return deducted only the company's share.

Q. The Schedule E you referred to is the gain from operations for Phase 2 computation, is that true?

A. Yes. We might note also that in Schedule E the required interest is the same for this Exhibit 14 and for the tax, 1958 tax return as filed, because again that required interest depends only on tabular assumptions and has no relation to the company's investment experience.

52 Q. Or the source of the investment income of the company?

A. Yes.

Q. Turning your attention to Exhibit 15, can you contrast that with the tax return as filed?

A. The tax liability as shown on page 1 of Exhibit 15 is $62,615.05, and is identical with the tax liability as shown in the 1958 tax return.

Q. Did Exhibit 15 include in investment yield all of the tax exempt income as did the tax return?

A. Yes, it did. The investment yield is identical with the two exhibits and it is the policy and other contract liability requirements. However, in Exhibit 15 in Schedule C, instead of deducting the entire policy and other contract liability requirements, we have reduced that reduction by the ratio of the policy and other contract liability requirements to the investment yield times the tax exempt interest.

In other words, we have deducted from the policy and other contract liability requirements a share of the company's tax exempt interest.

Q. Why did you do that in the preparation of this Exhibit 15?

A. That is the provision that was called for by the House Bill as originally passed.

Q. Were those Sections 805–E and 809 of H.R. 4245 as it originally passed?

A. Yes, they are. We did not discuss the fact that we made a similar reduction in Schedule E which is called for by the 809 section, and reduced the required interest in this case by a share of the company's tax exempt investment income.

Q. I believe you stated that using the adjustments called for under H.R. 4245, you arrived at the same taxable income as the tax return as filed?

A. That is correct.

Q. Turning your attention to Exhibit 16, can you contrast that with the tax return as filed?

A. Yes. In Exhibit 16 we have again made a calculation, following the format of the House Bill 4245 but this time we

have excluded entirely tax exempt interest from the investment yield.

Q. Did you make a further treatment of tax exempt income in the computation of the taxable investment income in Schedule C?

A. Yes. Then in Schedule C we have reduced the policy and other contract liability requirements by an amount of $20,006.73.

Q. Why did you do that?

A. The policy and other contract liability requirements, which emerged as a mathematical process when we eliminated the tax exempt income, was $20,006.73 less than the policy and other contract liability requirements emerging when we included tax exempt interest.

53

Thus, by excluding this $20,000 from the policy and contract liability requirements, we have completely eliminated that part of the policy and contract liability requirements which came about as a result of the receipt of tax exempt investment income.

Q. Now what is the tax liability shown on this Exhibit 16?

A. Tax liability shown here is equal to $51,362.86 and this is identically the same as that in our Exhibit 7.

Q. Directing your attention once again to Plaintiff's Exhibit 16, did you make any adjustment in the gain from operations Phase 2 computations?

A. No, I did not, because in this case the required interest did not depend in any way upon the company's receipt of tax exempt income, and thus it was not necessary to make any adjustment. Again, the gain from operations as it emerges in Schedule E is identical to the gain that emerged in our Exhibit 7.

Mr. SAUNDERS. Thank you, Mr. Delaney. You may inquire.

Cross-Examination By Mr. HRDLICKA:

Q. Mr. Delaney, I understand that you did not prepare the actual original returns for the company filed for the year 1958, is that correct?

A. Yes.

Q. But you did on the basis of that return as filed and adjustments that were agreed upon by the parties, you did prepare what we have been referring to as Exhibit No. 6, is that correct?

A. Yes.

Q. This exhibit right here?

A. Yes.

Q. And did you say that this exhibit—I believe you testified that this exhibit was computed under the directions for computing life insurance company taxable income as prescribed by the regulations, is that correct?

A. Yes.

Q. And by that do you mean that the item referred to as investment yield as determined and as allocated between policyholders and the company in arriving at the taxable income was taxable investment income for a life insurance company; is that basically the formula that was used?

A. Yes. The Schedule C excludes a share of the investment yield equivalent to the policyholders' share as calculated in the return.

Q. Now Exhibit 7, Mr. Delaney, or in Exhibit No. 7 you exclude from consideration completely all tax exempt interest is that correct?

A. Yes.

54 Q. Could you tell me what section of the 1954 Code that you relied on in doing that, what Code section governs your computations under this exhibit?

A. I believe 103–A but I would say only that I excluded the tax exempt interest in making the calculations.

Q. When you refer to Section 103 you are talking about the section that excludes from taxation interest received on certain bonds, municipal bonds and other local obligations, isn't that correct? A. Yes.

Q. What I am asking you, is there any specific section within the life insurance company income tax Act of 1959 which directed your exact method of computation, computing income tax as reflected in Exhibit No. 7?

A. I would say that the exception clauses were the basis on which that calculation was made.

Q. The exception clauses in Sections 804 and 809 which you are referring to? A. That's right.

Q. Well, going back then to Exhibit No. 6, do you recall Exhibit No. 6? A. Yes.

Q. Isn't it true that Section 804–A of the Internal Revenue Code of 1954, which I am showing you here, has a section which defines or deals with the exclusion of policyholders' share of investment yield? A. Yes.

Q. And isn't it Section 804–A that you would rely upon then in determining what percentage of total investment yield

should be excluded to policyholders? A. Certainly in following the tax return.

Q. Well, then my question to you is that with reference to Exhibit 7, is there any Code section similar to Section 804–A—I'm not talking now about the exception clauses—any section similar to 804–A in this Act which you followed in excluding from consideration entirely the tax exempt interest? A. Only the exception sections.

Q. Only the exception sections. Would that same be true, Mr. Delaney, of Exhibit No. 8?

A. Exhibit 8 was an illustrative exhibit to show that if the Tulsa jail bonds had been in default in the year 1958, that the tax paid by Atlas would have been less.

Q. I see. Then this is just on an assumption that something may have happened which didn't happen, is that correct? A. Yes.

Q. I mean this is not based on what actually did happen to to the company?

A. No. The company did receive $600.00 from Tulsa jail bonds.

Q. And then Exhibit 8 is computed following the regulations, as I understand it, but on the assumption that the company did not receive the $600.00? A. That is correct.

55 Q. Exhibit 9 then is a similar type of exhibit, isn't that correct, but the assumption here is that they received an additional $1000 of tax exempt interest; was that it?

A. Yes, the purpose of Exhibit 9 was to develop the company's marginal rate.

Q. But here again Exhibit 9 is computed on the basis of the Code and Regulations as they exist, is that right?

A. Yes, this is the kind of calculation the company would do to determine the tax they would pay, in making its investment decisions.

Q. What about Exhibit 10?

A. Exhibit 10, again, was an exhibit designed to show the effect of the marginal tax rate on tax exempt interest.

Q. And again this exhibit follows the same basic Code provisions as Exhibit No. 6, is that correct? A. That is correct.

Q. Now as I understood your testimony, Exhibits 11 and 12 were based upon the law that was in effect in 1942, is that correct?

A. Yes.

Q. And did you mean, did you compute this on the basis of the '42 Act as it applied to the year 1958 or as if it had applied to the year 1958? A. As if it had applied during 1958.

Q. Were you in computing Exhibits 11 and 12, were you applying the 1942 Act to the extent that it actually applied to the year 1957, or did you mean to apply just the '42 Act as it existed in '42?

A. We applied the '42 Act as it existed to the company's 1958 figures.

Q. Yes, but I mean was it the '42 Act as originally enacted or the '42 Act as amended?

A. No, it was the '42 Act as originally enacted.

Q. As originally enacted? A. Yes.

Q. I see. And your computations then in Exhibits 11 and 12 were based upon that Act? A. That is correct.

Q. Are these computations based in any way upon the Internal Revenue Code of 1954, the Life Insurance Company Income Tax Act of 1959?

A. Now I want to be sure. You mentioned 1954. You were talking about 1959?

Q. Yes. While I am talking about the 1954 Code, which includes the life insurance——

A. (Interposing.) No, no relation to the Life Insurance Company Income Tax Act of 1959.

Q. Then Exhibits 14 through 16, as I understand it, were based on the House Bill which had been considered at one point before adoption of the Life Insurance Company Act of 1959, but which was never passed, is that correct? A. That is correct.

56 Q. Mr. Delaney, might I ask when you made all these computations that we have seen in these various exhibits?

A. Well, at various periods of time. As you would guess, it takes a long time.

Q. How long ago did you make these calculations?

A. They have all been made subsequent to the Revenue Agent's report.

Q. Subsequent to the Revenue Agent's report?

A. They incorporate all of the changes that were made as a result of that report.

Q. Have you made computations similar to these computations with respect to other insurance companies prior to the time that you made these? A. Yes.

Q. Have you ever prepared exhibits similar to the ones we have now been looking at for the purpose of demonstrating possible differences between the Life Insurance Company Act of 1959 as opposed to the 1942 Act, or the House Bill that was considered in the 1959 Act? A. No.

Q. This is the first time you have prepared this type of exhibit? A. Yes.

Q. For that purpose. Mr. Delaney, since the Exhibit No. 7 in particular is not based upon—I am not speaking now of the exception clauses in the 1959 Act, but Exhibit No. 7 is not based upon the '42 Act or the House Bill and as far as I can determine it is not founded upon any particular provisions of the 1954 Code except the exception clauses, so whose decision was it to exclude the tax exempt from these computations? I mean whose idea was that?

A. This was my own idea. At the time the 1959 bill was passed, the exception clauses do provide that if it can be shown that tax investment income is taxed, adjustment shall be made and I think that by excluding it we find out whether or not it has been taxed. I think it has been taxed.

Q. Did you submit any of these computations to the Congress while it was considering the House Bill or Senate Bill?

A. Certainly I discussed these with people who were talking with—particularly Mr. Stanley Hill who was in Washington at this time.

Q. So that as far as you know, these computations were brought to the attention of Congress at the time it considered the Act?

A. I can't testify to my own knowledge about that.

Mr. SAUNDERS. If the Court please, I believe this is outside the scope of the direct examination and improper cross-examination.

57 The COURT. Well, overruled It's testing his experience with reference to these exhibits; 11, 12, 13, 14, why he made them and so forth.

Mr. HRDLICKA. Your Honor, I would just add that as complex as these computations are, it would be pretty hard for me to get outside the scope of direct examination. I think almost anything would apply to those.

Q. (By Mr. HRDLICKA). Mr. Delaney, are there any additional approaches that could be made to this problem except for the ones that you have presented here? I mean are there other possible ways you could rearrange the tax exempt interest and the various formula, allocation formula, and other items to make similar types of adjustments as you have demonstrated in your various exhibits here?

A. None that I know of.

Q. Well, do you think that as a mathematician or if you studied that you might devise additional ways of readjusting the allocation formula? I mean do you think you have exhausted the mathematical possibilities in treating these various items by the exhibits you have offered here?

A. I think we have exhausted reasonable possibilities.

Q. These exhibits then I take it represent all the possibilities you could think of?

A. Not all that I could think of, all the reasonable, all the reasonable ones.

Q. Did you make, did you consider making other computations based upon other hypothetical information, not the actual information of this company, but other hypothetical information that might apply to any insurance company?

A. Let me answer that by saying we make similar calculations to these in our own companies for purposes of determining our tax, yield after taxes.

Q. Well, isn't it possible for an insurance company, for example, to have a particular income structure so that by computing the company's tax the way you have demonstrated it in your Exhibits 7 and 14, would actually lead to a greater tax than what you have shown on those exhibits? I mean aren't there some times when you apply those principles of excluding tax exempt interest that you would actually come up with a greater tax than if you included the items in the computations?

A. I couldn't say that it was impossible. I would think it is very unlikely. Not in my experience has that arisen.

Q. Have you ever tried any computations along those lines to see if that would be possible?

58 A. We have in several companies made calculations similar to these, and that situation has not arisen.

Q. I believe that your Exhibit 14 is the one that reflects the greatest amount of tax refund, is that correct?

A. Yes, I believe so, that's the one that is the greatest.

Q. Now tell me this, if you assumed that this company's, all of the assets and all of the figures reflected in this return, were exactly the same as they are in Exhibit 14 but you assume further that the company had received no tax exempt interest whatsoever, in other words that it owned no tax exempt bonds but it still had the same amount in dollars of investment yield—do you follow my question so far?

A. Let me get with it. If we assume that all of the company's—the identical investment yield but no tax exempt interest?

Q. Right, but no tax exempt interest. A. Yes.

Q. And all other things being equal, would the tax be higher or less than that reflected in Exhibit 14, do you know?

A. The tax would be more than that reflected in Exhibit 14.

Q. Would be more than that reflected. So that in effect even in the most favorable computation here, the inclusion of tax exempt interest does result in a decreased tax?

A. No, Exhibit 14 is a calculation in which we have included tax exempt interest and its effect on the policy and other contract liabilities deduction, and have in effect then got the benefit of double deduction.

Q. I'm sorry, Mr. Delaney, my mistake. I was at the wrong end of the scale.

I want you to examine Exhibit 6, which shows the actual tax liability as reflected in the return originally filed. A. Yes.

Q. Now making the same assumption, that you have the same amount of investment yield but that you no tax exempt security, and that all other items in the return are the same, would the tax be greater or less than as reflected in that return, Exhibit No. 6?

A. The tax would be slightly greater. We are assuming here that we replace the $36,000 of tax exempt by $36,000 of fully taxable income.

Q. Right. I am assuming that there would be no side effect on policy and other contract liabilities or your earnings rate or anything like that?

A. Right. The tax would be slightly greater. Specifically, the Schedule C, taxable investment income would be increased by $5,372.42 which is the company's share of tax exempt interest, and Schedule E would be increased by $4,600—$4,618.75.

Q. I see. Thank you.

59 Mr. Delaney, I believe that you testified with respect to Exhibit No. 7 where you completely excluded tax exempt interest, you came up with a slightly different adjusted life insurance reserve and a slightly different adjusted reserve rate, is that correct?

A. That is correct.

Q. That is shown on Schedule E.

A. Well, it is shown here on Schedule B.

Q. On Schedule B. I'm sorry. This is not too clear.

Now in Part 2, entitled "Assets," did you exclude the tax exempt securities from assets or were they allowed to remain in assets?

A. They were allowed to remain in assets. We assume in effect that the tax exempt securities had not earned any money, that the money was perhaps lying in the bank idle.

Q. They existed as assets but earned no income, is what your assumption was? A. Yes.

Q. Now that assumption under your computations led to a policyholder's share under Section 804 of 86.649%, which is reflected on page 3, is that right? A. Yes.

Q. Schedule C, line 1? A. Yes.

Q. Which is a slight increase over that same percentage reflected in Exhibit 6, isn't that correct? A. Yes.

Q. Now that increase or that percentage is applied to all investment yield, isn't that right?

A. Yes. In this case we have already excluded the tax exempt interest.

Q. Right, so that——

A (Interposing). Confines this percentage to a smaller total investment yield.

Q. You are in effect putting over to the policyholders a greater percentage of investment yield that remains after the tax exempt securities or tax exempt income is taken out of investment yield, isn't that correct? A. Well, this is simply a mathematical calculation.

Q. Right. A. Excluding tax exempt interest.

Q. But the end result is that the greater percentage is excluded and attributed to the policyholders' share?

A. The end result is that we do secure a larger exclusion for other items of investment yield.

Q. And of course the greater percentage of investment yield that is attributable to the shareholders, the less that is taxed to

the company, isn't that correct? I mean that just follows as a mathematical——A. Please state that again.

60 Q. I say the greater percentage of the investment yield that is attributed to the policyholders, the less the percentage that is taxed to the company, isn't that correct?

A. The less is the company's share, I'll certainly agree to that.

Q. Was it your testimony that the assumed interest rate has no bearing whatever on the actual interest rate or no relationship whatever to the actual interest rate?

A. In the tax form, certainly, there is a very loose relationship between when a company establishes the basis of its reserves, of course it is restricted by the statute in the interest rate it can assume, also usually has some loose relationship to its actual investment earnings, but there are many other factors to be considered as well.

Q. Well, isn't the assumed interest rate applied to investment assets to try and anticipate the earnings on those assets for future years, to be added to reserves? A. I would say no.

Q. How is the assumed interest rate applied?

A. The life insurance reserves increase each year by an amount equal to the assumed interest rate times the reserve. There is increase in reserve as a result of the interest assumption. I might say it that way.

Q. So you apply your assumed interest rate to the reserves and that will give you an increase in the reserve for the following year, is that correct?

A. That is part of the increase in reserve, that part attributable to interest.

Q. Then there are other factors that also affect the reserve itself, is that correct?

A. Yes, the net premium and the valuation basis and so forth.

Q. Now with respect to, I believe it was Exhibit 7 on the Phase 2 computation on Schedule E, a question was asked you whether—I am not sure I've got the right exhibit here but I think you can correct me if I don't—a question was asked you whether the tax exempt interest had any effect, or the actual interest rate on tax exempts had any effect on the computation reflected in Schedule E, and I believe you stated it didn't, is that correct?

A. *I* has no effect on the required interest.

Q. The required—what is the reason for that?

A. Required interest is based on tabular assumptions, the assumed interest rate, the assumed reserve structure.

Q. So in that respect the tax exempt securities are no different than any other security, are they?

A. That's correct. The receipt of any investment income has no effect on this required interest.

61 Q. So what you really are stating then in a broader sense is that this is computed on the basis of an assumed interest rate, which is not necessarily the same and really has no relation to, except the one you have previously explained, to the actual earnings rate?

A. That is correct.

Q. Mr. Delaney, I have only one further question I would like to ask you. You testified with respect to certain marginal tax computations and in connection with that you showed how certain different treatment of certain items can affect tax liability. Isn't it true that there are a lot of different items that can affect tax liability of an insurance company? Let's say for example that an insurance company, all other factors remaining equal, if it merely increased its cash on hand, idle cash on hand, could you tell us what effect that would have on that company's liability under the '59 Act?

A. I am not sure how would it—how it would increase its cash on hand.

Q. Well, I'm talking about, it would be an increase on hand, it would be included within assets under Section 805?

A. It would have to effect this increase in some way. Would it sell some of its security?

Q. I was attempting to maintain the investment yield the same and so I didn't want to have—let's assume there is a sale of an item which had not previously been included in the definition of assets under Section 805 and a sale of that type of item was made and the idle cash was in the bank, so in effect you had an increase of assets under Section 805, but no increase in investment yield.

What would the effect of that be on the company?

A. This would cause a slight increase in tax.

Q. Slight increase in tax. And aren't there a lot of other items similar to this which could affect the company's tax even though there is no actual difference in the company's income? For example, idle cash produces no more income but yet with

the addition of idle cash you would have a greater tax under the Act. Aren't there other types that would have the same effect?

A. There might be. I can think of none.

62 ROBERT D. ALLEN, called as a witness on behalf of the plaintiff, being of lawful age and having first been duly sworn, testified as follows:

Direct Examination By Mr. SAUNDERS:

Q. State your name, please. A. Robert D. Allen.

Q. Where do you live, Mr. Allen? A. Oklahoma City.

Q. What is your occupation?

A. I am the Assistant Insurance Commissioner, Chief Counsel, the Oklahoma Insurance Department.

Q. How long have you held that position?

A. Slightly over five years.

Q. What, generally speaking, are your duties in that position?

A. Well, the Commissioner's office, we handle the licensing of all companies. That includes life, casualty and property. That's originally applying companies, and also the renewal licenses annually. We collect the annual premium taxes, conduct examinations of all companies domestic, participate in the examination of all foreign companies doing business in Oklahoma from time to time.

Also I have general house counsel responsibility with the Commissioner's office.

Q. In connection with the performance of your duties, are you familiar with the statutory reserve requirements of the State of Oklahoma with reference to life insurance companies in Oklahoma?

A. Yes, I am. The life reserve requirements as set out in Section 1510, Title 36, Oklahoma Statutes 1961.

Q. From the standpoint of the Insurance Commissioner's Office and the performance of your duties, what are the life insurance reserves that are determined under the Oklahoma statutes?

A. Well, all policy reserves are liabilities of the company under our statute.

Q. Are they determined under actuarial tables?

A. Well, yes, the determination of the reserves is made on the basis of the classes of policies, the actuarial tables employed, and the interest assumed. They vary from classes of business.

Q. In your opinion, what is the purpose of having a life insurance company estimate or calculate its insurance liability annually and then include them in an annual report filed in your office?

A. Well, of course our purpose is, it's a statutory requirement and it is a test to determine the solvency of the company and its eligibility to transact insurance. The liabilities, policy liabilities are deducted from their admitted assets. We have a statutory minimum capital and surplus which the company has to maintain in order to hold its license.

63 Q. Are the reserve liabilities of Oklahoma insurance companies reflected on the books of the Oklahoma companies?

A. No, the only way you can get into a determination of that is by an inventory of the business in force.

Q. And you would apply the proper—— A. Statutory test.

Q. Is there any requirement of the Oklahoma Insurance Department with reference to a company segregating or earmarking assets to meet it reserve liability?

A. No, not only is there no requirement that they segregate, we would not permit segregation of the company's assets, they stand for all the liabilities of the company.

Q. How does the Oklahoma Insurance Department conduct an examination of an insurance company, in particular Atlas?

A. I think Atlas just went through one. I believe that—well, of course there are field audits. They are very comprehensive. Primarily our examiners are, we try to draw on ex-FBI people and men of some repute and ability in accounting. It's about like a federal bank examination. We count, physically count securities, verify accounts as necessary to determine their verity. It's a field audit.

Q. Are you checking their assets among other things?

A. Well, the purpose of it is to determine assets and liabilities.

Q. Can you explain, Mr. Allen, in general terms the Oklahoma statutory requirements as to investment by life insurance companies?

A. Well, our investment statutes as they pertain to life insurance companies are in the nature of limitations. Investment policies are the responsibility of the management of the company and we have percentage limitations that apply to various classes of investment, with certain exceptions. A

company may invest any of its funds in U.S. Government obligations, general obligations of states and municipalities. In other areas, like corporates, common stocks, there are percentage limitations that are applied against the company's admitted assets.

Q. Can a domestic Oklahoma life insurance company invest in a corporate stock which does not pay cash dividends, pays dividends in stock?

A. Our statute requires that any stock that the company invests in be dividend paying. As far as the requirement being a cash dividend, it is not so expressed in the statute. We wouldn't require it. There is a test with respect to earnings. They have to earn a certain ratio available for dividends against fixed charges to be an eligible investment, but they have to be dividend paying, but that would not necessarily have to be a cash dividend.

64 Q. Mr. Allen, do you know the purpose of these investment requirements in the Oklahoma Insurance Code?

A. Well, you can tell pretty well from considering them, but the Legislature in Oklahoma wants the companies operated on a conservative basis and it gives them actually an enforced and broad investment base on which to operate that company, without getting into specific investments.

Q. Does the Insurance Commissioner's Office ever recommend that a life insurance company change the type of its investments, assuming that it is operating within the statutory requirements?

A. No, investment policies are the responsibility of management except we have these limitations on the classes of securities that they can get into and the amounts which can be invested, but that's the only limitation.

Q. Mr. Allen, does your department ever question the company's investments if the rate of return on the investments aggregate during the year does not equal or exceed the interest rate assumed by the company in computing these reserves?

A. Actually we don't concern ourselves with the company's investment yield or rate of return as such, unless it is a situation where solvency is threatened. The answer to your question would be "no, we don't."

Q. Would a growth stock that paid no dividends be a qualified investment for the purpose of determining solvency?

A. A growth stock that paid no dividends?

Q. Uh huh.

A. Under our statute, unless it was a dividend paying security, the company would not be authorized to invest in it.

Q. After an investment had been made in authorized stock but then if it stopped paying dividends but it was a growth stock, appreciating in value, is my real question, Mr. Allen, is that a permitted asset?

A. Well, certainly, eligibility of an investment under our statute is determined as of the date of acquisition, if they cease paying dividends later on it would still be carried as an admitted asset.

Q. And would the value of that stock, whether or not it paid dividends, be included in a test for solvency? A. Certainly.

Mr. SAUNDERS. I believe that is all.

Cross-Examination By Mr. HRDLICKA:

Q. Mr. Allen, what action is taken by the Insurance Commissioner's Office in the event an insurance company has assets insufficient to meet its reserves?

65. A. Well, if it has assets which are insufficient to meet any of its liabilities, we have—if it is impaired less than 20%, we give them sixty days' notice to make restoration. If it is impaired more than 60%, pardon me, more than 20%, then we are required to take some type of rehabilitation action.

Q. And what might that include?

A. Oh, it could be a *conservership* or a receivership.

Mr. SAUNDERS. This concludes the presentation of plaintiff's case, your Honor.

The COURT. Very well. Let the record show that the plaintiff rests its case.

* * * * *

The COURT. Let the record show that defendant rests its case. Does counsel care to make an argument in this case?

66–74. * * * * *

[Clerk's Certificate to foregoing transcript omitted in printing.]

IN UNITED S....S DI....T COURT for the northern District

Plaintiff's Exhibit 6

FORM 1120 L — U.S. LIFE INSURANCE COMPANY INCOME TAX RETURN — FOR CALENDAR YEAR 1958

PLEASE TYPE OR PRINT PLAINLY

The Atlas Life Insurance Company

415 South Boston Avenue, Tulsa 1, Oklahoma

September 25, 1918 Oklahoma

01-05132

35,485.55

Not applicable to this company

430,508.05

☐ Yes ☒ No

☐ Yes ☒ No

☒ Yes ☐ No

☐ Yes ☒ No

LIFE INSURANCE COMPANY TAXABLE INCOME

1. (a) The taxable investment income (Schedule C) 100,760.87
   (b) The gain (loss) from operations (Schedule D) 161,229.68
   (c) The smaller of (a) or (b) 100,760.87
2. 30 percent of the excess, if any, of (b) over (a) 30,229.02
3. Life insurance company taxable income (Total lines 1(c) and 2) tax treatment used 130,989.89

COMPUTATION OF TAX DUE OR REFUND

4. If amount of line 3 is:
   (a) Not over $25,000—
   Enter 30 percent of line 3 (22 percent if a consolidated return)
   (b) Over $25,000—
   Enter 52 percent of line 3 (54 percent if a consolidated return) 68,115.05
   Subtract $5,500, and enter difference 5,500.00 62,615.05
5. Less: Credit allowed a domestic corporation for income taxes paid to a foreign country or United States possession (Submit Form 1118)
6. Total income tax (line 4 less line 5) 62,615.05
7. Credits for amounts paid on 1958 income tax:
   (a) Tax paid with application for extension of time in which to file 64,055.79
   (b) Payments and credits on 1958 Declaration of Estimated Tax 64,055.79
8. If tax (line 6) is larger than payments (line 7), the balance is TAX DUE. Enter such balance here
9. If payments (line 7) are larger than tax (line 6) Enter the OVERPAYMENT here
10. Enter amount of line 9 you want: Credited on 1959 estimated tax 0
    Refunded 1,440.74

SIGNATURE AND VERIFICATION (See Instruction E)

Declare under the penalties of perjury that this return (including any accompanying schedules and statements) has been examined and to the best of my knowledge and belief is a true, correct, and complete return. If the return is prepared by a person other than the taxpayer, his declaration is based on all the information relating to the matters required to be reported in the return of which he has knowledge.

CORPORATE SEAL

(Date) (Signature of officer) (Title)

(Date) (Individual or firm signature) (Address)

166

EXHIBIT 1 PX 6 FORM 1120 L—1958

SCHEDULE A—INVESTMENT YIELD (See Instructions)

Gross Investment Income (Section 804(b))	1. Interest Received	2. Amount of Deduction	3. Balance (Col. 1 less Col. 2)	4. Mean of Beginning and End of Year Amounts
1. Interest on:				
(a) [illegible]	35,796.15	1,687.00	784.38	36,637.79
(b) [illegible]	0	0	0	0
(c) [illegible]	0	0	0	0
(d) [illegible]	46,445.34	25.00	11.00	46,459.34
(e) [illegible]	6,315.69	6,309.98	5,953.05	6,321.72
(f) [illegible]	973,457.47	5,982.98	6,749.41	974,669.74
2. Dividends on stock of:				
(a) Domestic corporations subject to taxation under Chapter 1, I.R.C.				0
(b) Certain preferred stock of public utilities taxable under Chapter 1, I.R.C.				0
(c) Foreign corporations				0
(d) Other corporations				0
3. Rents. (Attach schedule)				164,995.28
4. Royalties. (Attach schedule)				0
5. Leases, terminations, etc.				0
6. Gross income from trade or business other than investment business. (Attach schedule)				0
7. GROSS INVESTMENT INCOME (total lines 1-6)				1,139,662.02
Deductions (Section 804(c))				
8. Investment expenses. (Attach schedule) (See Schedule H)				104,602.57
9. Real estate expenses. (Attach schedule)				121,534.99
10. Depreciation. (Attach schedule)				19,249.85
11. Depletion of mines, oil and gas wells, timber, etc. (Attach schedule)				0
12. Trade or business deductions as provided in 804(c)(3) (Attach schedule)				0
13. Total deductions (lines 8-12)				245,387.41
14. INVESTMENT YIELD (line 7 less line 13)				894,277.61

SCHEDULE B—PART I—POLICY AND OTHER CONTRACT LIABILITY REQUIREMENTS (Sec. 805(a)) (See instructions)

1. Adjusted life insurance reserves (from Part V)	22,090,965.26	
2. Multiplied by the adjusted reserves rate (lesser of line 1 or 7, Part III)	3.253782 %	718,791.00
3. Interest paid (from Part VI)		42,352.47
4. Policy and other contract liability requirements (Total of lines 2 and 3)		761,143.28

PART II—ASSETS (Sec. 805(b)(4))

	1. Beginning of Taxable Year	2. End of Taxable Year	3. Mean of Beginning and End of Year Amounts
1. Real estate	1,025,538.20	1,042,261.22	1,033,999.71
2. Mortgages:			
(a) Without service fees	3,485,485.50	3,376,927.90	3,431,206.70
(b) With service fees	5,733,561.81	5,599,697.64	5,669,729.72
	275,700.00	272,700.00	274,200.00
3. Collateral loans	2,043,403.58	2,233,301.02	2,138,352.30
4. Policy loans, including premium notes	9,437,901.55	9,658,676.15	9,548,288.85
5. Corporate bonds	0	0	0
6. Stocks	1,713,602.00	2,402,436.00	2,058,019.00
7. Government obligations, etc. (Submit detailed schedule)	987,735.07	1,389,783.39	1,188,759.23
8. Bank deposits, cash, etc.	1,282,546.89	1,213,936.32	1,248,241.61
9. Other assets (Attach schedule)			
10. Totals	25,985,678.00	27,661,919.64	26,823,799.82

*Allowed under Section 805(a) (Attach schedule)

PART III—EARNINGS RATES (Sec. 805(b))

1. Current earnings rate (line 14, Schedule A divided by line 10, column 3, Part II)	3.333330
2. Earnings rate for first preceding year (Attach schedule)	3.[illegible]
3. Earnings rate for second preceding year (Attach schedule)	3.[illegible]
4. Earnings rate for third preceding year (Attach schedule)	3.[illegible]
5. Earnings rate for fourth preceding year (Attach schedule)	3.[illegible]
6. Total (lines 1-5)	16.[illegible]
7. Average earnings rate (See instructions)	3.253782

EXHIBIT 1

PART IV—AVERAGE INTEREST RATE (Section 805(b))

1. Name of Obligor	2. Interest Payment Dates	3. Int. Rate (Effective Rate)	4. Amount of Indebtedness	5. Amount of Discount or Premium	6. Other Consideration	7. Int. Rate
1. Life	Varies	Varies	20,548,850.00	20,786,550.00	267,700.00	693,959.28
2. Annuities	Varies	Varies	891,707.00	989,473.00	990.34	25,342.40
3. SGLIC	Varies	Varies	98,050.28	177,283.00	166,666.00	5,697.00
4. OSDAY	Varies	Varies	515,194.67	583,134.01	544,144.35	16,496.07
5. Totals					978,501.69	741,494.75

6. Average rate of interest computed in accordance with instructions (divide Column 7 total of column 5 divided by total of column 7) 3.40-25

* The interest for SGLIC and OSDAY is computed quarterly. Actual quarterly rates differ slightly.

PART V—ADJUSTED LIFE INSURANCE RESERVES (Sec. 805(b))

1. Items A of the reserves (col. 7, line 5, Part IV)		21,763,894.05
2. 1/ Multiplied by that percentage which equals	100%	
(a) Increased by 10 times the average rate of interest assumed (from line 6, Part IV)	134.04200	
(b) Total	32.51762	
(c) Reduced by 10 times the adjusted reserve rate (from line 2, Part I, Schedule D)		101,500.00
(d) Line (c) from line (b)		22,020,900.28
3. Adjusted life insurance reserves (line 1 multiplied by line 2(d))		

PART VI—INTEREST PAID (Sec. 805(b))

1. Interest on indebtedness	43,000.00
2. Amounts in the nature of interest	
3. Discount on purchased positions	
4. Total interest paid (lines 1-3)	

SCHEDULE C—TAXABLE INVESTMENT INCOME (See Instructions)

1. Policyholders' share (Sec. 804) (line 4, Part I, Sch. B) divided by line 14, Sch. A) but not to exceed 100%	85.33000	
2. Company's share		
3. Total		

	1. Total	2. Deferred Policyholders' share (line 3)	3. Company's share (line 2 - 1)
4. Interest wholly tax-exempt (line 11(a), column 4, Schedule A)	36,637.79	31,265.37	5,372.42
5. Interest partially tax-exempt (lines 11(b) and (d), column 4, Schedule A)	0	0	0
6. (a) Dividends from line 2(a), Schedule A	0	0	0
(b) Dividends from line 2(b), Schedule A	0	0	0
(c) Dividends from line 2(c), Schedule A	0	0	0
(d) Dividends from line 2(d), Schedule A	0	0	0
7. Other items of investment yield (line 14, Schedule A, less 4-6 above)	857,639.82	731,868.95	125,760.87
8. Total (Lines 4-7)	894,277.61	763,134.32	131,133.29

REDUCTIONS

9. Interest wholly tax-exempt (line 4, column 3)		5,372.42
10. Interest partially tax-exempt (25/52 of line 5, column 3)		
11. Dividends received deduct on:		
(a) 85% of dividends from line 6(a), column 3	0	
(b) 62.1135% of dividends from line 6(b), column 3	0	
(c) 85% of dividends from certain foreign corporations from line 6(c), column 3	0	
(d) Total, but not to exceed 85% of taxable investment income (line 14, Schedule C) computed without regard to this deduction		0
12. Small business deduction (10% of line 14, Schedule A, not to exceed $25,000)		25,000.00
13. Total (lines 9, 10, 11(d) and 12)		30,372.42
14. Taxable investment income (line 8 less line 13, but not less than zero)		100,760.87

18

EXHIBIT 1

1.—GAIN AND LOSS FROM OPERATIONS (See instructions)			
...holders' share (Sec. 809 (d)(5) Sch. I, Sch. I-1 divided by line 14, Sch. A) but not to exceed 100%			87.193...
...Company's share			12.806...
...	1. Total	2. Separate Accounts (Identify Titles on ...)	
...ed wholly tax exempt (line 1(a), column 4, Schedule A)	36,937.79	32,019.04	4,918.75
...ed partially tax exempt (lines 1(b) and (d), column 4, Schedule A)	0	0	0
...) Dividends from line 2(a), Schedule A	0	0	0
(d) Dividends from line 2(b), Schedule A	0	0	0
...) Dividends from line 2(c), Schedule A	0	0	0
...) Dividends from line 2(d), Schedule A	0	0	0
3. Other items of investment yield (line 14, Schedule A line 4-6 above)	657,619.82	749,521.28	106,118.54
4. Total (lines 1-3)	694,277.61	781,540.32	112,737.29
5. Gross premiums 6,319,787.11 Less: Return premiums etc. 151,066.25			6,168,720.86
6. (a) Decrease in reserves (after adjustment under 810(d)) (Attach schedule)			0
(b) Decrease in 811(b)(2) reserves (See line 3, Part IV, Schedule B-2)			0
11. Other amounts (Attach schedule)			552.22
12. Total (lines 5-11)			6,282,920.64
DEDUCTIONS			
13. Death benefits, etc.			3,612,465.00
14. Increase in reserves (after reduction for investment yield under 810(b)) (Attach schedule)			889,041.69
15. Assumption by another person of liabilities under insurance, etc., contracts			0
16. Interest wholly tax-exempt (line 4, column 3)			4,918.75
17. Interest partially tax-exempt (85/52 of line 5, column 3)			0
18. Investment expenses, etc., not deducted on Schedule A (Attach schedule)			10,183.63
19. Small business deduction (10 percent of line 14, Schedule A, not to exceed $25,000)			25,000.00
20. Other deductions not deducted on Schedule A (Attach schedule)			2,170,673.30
21. Total (lines 13-20)			5,712,282.37
22. Dividends received deduction (See instructions)			
(a) 85% of dividends received from line 6(a), column 3	0		
(b) 62.115% of dividends from line 6(b), column 3	0		
(c) 85% of dividends from certain foreign corporations from line 6(c), column 3	0		
(d) Total, but not to exceed 85% of the excess, if any, of line 12 over line 21			0
23. Operations loss deduction (Attach schedule)			5,428,561.93
24. Tentative deduction (lines 21-23)			284,358.71
25. Plus: (a) Group life, accident, and health insurance (line 7, Part I, Schedule B-2)			284,358.71
(b) Certain nonparticipating contracts (line 8, Part I, Schedule B-2)			0
(c) Dividends to policyholders (line 11, Part I, Schedule B-2)			0
26. Total deductions (line 24 plus line 25)			284,358.71
27. Gain (loss) from operations (line 12 less line 26)			10,220.00

EXHIBIT 1

SCHEDULE D-6.—REQUIRED INTEREST (Sec. 809(d)(5))

Page 4

	1. Rate	2. Beginning of Taxable Year	3. End of Taxable Year	4. Mean (Columns 2 plus 3)	5. Column 4 (mean) multiplied by Column 1 (rate)
1. 809(d)(2) Reserves from line 2, column 6, Part IV, Schedule D					740,876.03
2. 809(d)(3) Reserves	Various	730,213.00	705,412.00	717,844.00	21,691.29
3. 809(d)(4) Reserves	Various	490,726.00	534,839.00	512,782.00	17,849.16
4. 809(d)(5) Reserves	Various	50,218.21	62,167.01	56,192.61	1,123.84
5. Required reduction (Total of lines 1—4)					781,540.32

SCHEDULE D-6.—PART I—LIMITATION ON LINE 22, SCHEDULE E DEDUCTION (Sec. 809(f))

1. Statutory amount		250,000
2. (a) From line 12, Schedule E	9,282,080.34	
(b) Less: Tentative deduction, line 24, Schedule E	8,492,565.34	
3. Gain from operations (offset copied to line 28, Schedule E	789,455.00	
4. Less: Taxable investment income (line 14, Schedule C)	100,760.87	688,694.13
5. Excess of line 3 over line 4 (but not less than zero)		938,694.13
6. Maximum possible deduction for line 22, Schedule E (line 1 plus line 5)		47,749.74
7. Deduction for group life, accident, and health insurance (Part II) (Not in excess of line 6)		890,944.39
8. Maximum deduction for certain nonparticipating contracts (line 6 less line 7)		127,116.96
9. Deduction for certain nonparticipating contracts (Part III) (Not in excess of line 8)		763,827.43
10. Maximum deduction for dividends to policyholders (line 8 less line 9)		453,368.22
11. Deduction for dividends to policyholders (Part IV) (Not in excess of line 10)		

PART II—GROUP LIFE, ACCIDENT, AND HEALTH INSURANCE (Sec. 809(d)(9))

1. Net premiums		2,387,487.15
2. Multiplied by		47,749.74
3. Tentative deduction		

PART III—CERTAIN NONPARTICIPATING CONTRACTS (Sec. 809(d)(10))

1. (a) Reserve at the end of the taxable year	20,550,115.02	
(b) Reserve at the beginning of the taxable year	19,278,945.38	
(c) Increase (if the difference is negative, enter "0")	1,271,169.64	
(d) Multiplied by	10%	127,116.96
2. (a) Net premiums	3,065,676.34	
(b) Multiplied by	3%	91,970.29
3. Tentative deduction—the greater of line 1 or line 2		127,116.96

PART IV—DIVIDENDS TO POLICYHOLDERS (Sec. 809(d)(5))

1. Dividends paid to policyholders		444,456.63
2. (a) Increased by the excess of (1) over (2):		
(1) Reserve as of the end of the taxable year	204,949.47	
(2) Reserve as of the end of the preceding taxable year	196,037.88	8,911.59
OR		
(b) Decreased by the excess of (1) over (2):		
(1) Reserve as of the end of the preceding taxable year		
(2) Reserve as of the end of the taxable year		
3. If positive, enter on line 11, Schedule D-2; if negative, enter on line 10(b), Schedule E		453,368.22

170

EXHIBIT 1

Page 4a

1. Balance as of January 1, 1959			130,990.48
2. Life insurance company taxable income			0
3. Formerly tax-exempt interest deduction (Section 247 of Form 1120 and 164, column 4, Schedule A)			
4. Dividends received deduction:			
(a) 85% of dividends received from line 26(a), Schedule A		0	
(b) 82.115% of dividends received from line 26(b), Schedule A		0	
(c) 85% of dividends received from wholly foreign corporations		0	0
(d) Total. Not part to exceed 85% of line 12 less line 31, Schedule E			36,637.79
5. Interest wholly exempt less line 14(c), column 4, Schedule A)			25,000.00
6. Small business deduction (See 18, Schedule D			192,620.27
7. Total (Limit 1-6)			62,615.43
8. Less: Tax liability for 1959 (under 6258a)			130,013.22
9. Excess of line 7 over line 8			70,000.00
10. Less: Distributions in 1959 (Not to exceed line 9)			60,013.22
11. Balance as of December 31, 1959 (line 9 less line 10)			

SCHEDULE E.—LIMITATION OF INVESTMENT EXPENSE DEDUCTION (Schedule E need not be filled in if no deduction is claimed for any general expenses that are allocable to investment income.)

1. Mean of the assets for the taxable year (line 10, column 3, Part II, Schedule B)			26,021,798.62
2. One-fourth of 1% of the mean of the assets (line 1)			67,049.50
3. Mortgage service fees			28,965.05
4. The greater of (a) or (b):			
(a) (i) Investment yield computed without regard to investment expenses		1,147,641.26	
(ii) Three-and three-fourths percent of line 1		1,005,892.46	
(iii) Excess (line (i) over line (ii))		141,748.80	
(iv) One-fourth of line (iii)		35,437.20	
(v) Reduced by mortgage service fees from 3		28,965.05	
(vi) Line (v) less line (v)		6,472.15	
(b) One-fourth of 1% of the amount on line 2(a), column 3, Part II, Schedule B		8,578.02	8,578.02
5. Limit on deduction for investment expenses (Total lines 2-4)			104,602.57

K. Did you at any time during the taxable year own directly or indirectly 50% or more of the voting stock of a domestic corporation?
☐ Yes ☒ No

L. Did any corporation, individual, partnership, trust, or association at any time during the taxable year own directly or indirectly 50% or more of your voting stock?
☐ Yes ☒ No
If either answer is "Yes," see instruction N.

M. Did you at any time during the taxable year own directly or indirectly any stock of a foreign corporation? (If "Yes," attach statement required by General Instruction J.)
☐ Yes ☒ No

N. Did you file with the District Director a copy of the annual statement for the preceding year as required by General Instruction K?
☒ Yes ☐ No If "Yes," state office in which filed.
Oklahoma City, Oklahoma

O. If a copy of the annual statement does not accompany this return, state why the statement is not attached.
Filed with original return

EXHIBIT 1

c-1.

SCHEDULE G.—POLICYHOLDERS SURPLUS ACCOUNT (Sec. 815(a)) Page 4

1. Balance as of the beginning of the taxable year			
2. Add: (a) 50 percent of the excess, if any, of the gain from operations over the taxable investment income (line 2, page 1)		30,229.61	
(b) The deduction for certain computer-software contracts (line 25(a), Schedule D)		127,116.96	
(c) The deduction for group life, accident, and health insurance (line 25(c), Schedule D)		47,749.74	205,096.31
3. Total (line 1 plus line 2)			205,096.31
4. Less: (a) Actual distributions only to excess of line 10, Schedule F		0	
(b) Tax increase on 4(a) by reason of 809(b)(3)		0	
(c) Amounts treated as distributions (See instructions)		0	
(d) Tax increase on 4(c) by reason of 809(b)(3)		0	
(e) Subtractions required under 815(b)		0	0
5. Total of lines 4(a)–(d) (Not to exceed line 3) (Enter here and on line 3, page 1)			205,096.31
6. Balance as of the end of the year (line 3 less line 5)			

172.

EXHIBIT 1

IN THE UNITED STATES DISTRICT COURT

FORM 1120 L — U.S. LIFE INSURANCE COMPANY INCOME TAX RETURN — FOR CALENDAR YEAR 1958 — 2030

Do not write in space below

PLEASE TYPE OR PRINT PLAINLY

Plaintiff's Exhibit 7

The Atlas Life Insurance Company

415 South Boston Avenue, Tulsa 3, Oklahoma

September 25, 1918 — Oklahoma — 01-0513Z

35,485.55	Not applicable to this company	430,508.05

LIFE INSURANCE COMPANY TAXABLE INCOME

(a) The taxable investment income (Schedule C)	89,502.27	
(b) The gain (loss) from operations (Schedule D)	129,201.04	
(c) The smaller of (a) or (b)		89,502.27
50 percent of the excess, if any, of (b) over (a)		19,849.39
Life insurance company taxable income (Total lines 1(c) and 2)		109,351.66

COMPUTATION OF TAX DUE OR REFUND

If amount of line 3 is:		
(a) Not over $25,000— Enter 30 percent of line 3 (32 percent if a consolidated return)		
(b) Over $25,000— Enter 52 percent of line 3 (54 percent if a consolidated return)	56,862.86	51,362.86
Subtract $5,500, and enter difference	5,500.00	
Less: Credit allowed a domestic corporation for income taxes paid to a foreign country or United States possession (Submit Form 1118)		0
Total income tax (line 4 less line 5)		51,362.86
Credits for amounts paid on 1958 income tax:		
(a) Tax paid with application for extension of time in which to file	64,055.79	
(b) Payments and credit on 1958 Declaration of Estimated Tax		64,055.79
If tax (line 6) is larger than payments (line 7), the balance is TAX DUE. Enter such balance here		
If payments (line 7) are larger than tax (line 6) Enter the OVERPAYMENT here		12,692.93
Enter amount of line 9 you want: Credited on 1959 estimated tax		
Refunded	12,692.93	

SIGNATURE AND VERIFICATION (See Instruction E)

I declare under the penalties of perjury that this return (including any accompanying schedules and statements) has been examined by me and, to the best of my knowledge and belief is a true, correct, and complete return. If the return is prepared by a person other than the taxpayer, his declaration is based on all the information relating to the matters required to be reported in the return of which he has knowledge.

CORPORATE SEAL

(Date) (Signature of officer) (Title)

(Date) (Individual or firm signature) (Address)

173

EXHIBIT 2 — PX 7. — FORM 1120 L—1958

Page 3

SCHEDULE A—INVESTMENT YIELD (See instructions)

Line no.	Gross Investment Income (Section 804(b))	1. Interest Received	2. Accrual of Discount	3. Amortization of Premium	4. Total (Use Col. 2 plus Col. 1 less Col. 3)
1.	Interest on:				
	(a) Bonds issued by obligors, except subsidiaries	(35,796.13)	(1,627.00)	(785.36)	(36,637.79)
	(b) Bonds issued by subsidiaries	0	0	0	0
	(c) Obligations guaranteed by the United States as to principal or interest	0	0	0	0
	(d) Other bonds (unless specifically exempt from tax)	46,445.34	25.00	11.00	46,459.34
	(e) Loans, notes, collateral loans, bank deposits, bonds, debentures, etc.	891,215.68	6,309.98	5,953.05	891,572.61
	Totals	937,661.02	6,334.98	5,964.05	938,031.95
2.	Dividends on stock of:				
	(a) Domestic corporations subject to taxation under Chapter 1, I.R.C.				0
	(b) Certain preferred stock of public utilities taxable under Chapter 1, I.R.C.				0
	(c) Foreign corporations				0
	(d) Other corporations				0
3.	Rents. (Attach schedule)				164,995.28
4.	Royalties. (Attach schedule)				0
5.	Leases, terminations, etc.				0
6.	Gross income from trade or business other than insurance business. (Attach schedule)				0
7.	GROSS INVESTMENT INCOME (total lines 1–6)				1,103,027.23
	Deductions (Section 804(d))				
8.	Investment expenses. (Attach schedule) (See Schedule H)				104,602.57
9.	Real estate expenses. (Attach schedule)				121,534.99
10.	Depreciation. (Attach schedule)				19,249.85
11.	Depletion of mines, oil and gas wells, timber, etc. (Attach schedule)				0
12.	Trade or business deductions as provided in 804(d)(2) (Attach schedule)				0
13.	Total deductions (lines 8–12)				245,387.41
14.	INVESTMENT YIELD (line 7 less line 13)				857,639.82

SCHEDULE B—PART I—POLICY AND OTHER CONTRACT LIABILITY REQUIREMENTS (Sec. 805(a)) (See instructions)

1.	Adjusted life insurance reserves (page Part V)	22,375,659.00
2.	Multiplied by the adjusted reserves rate (lesser of lines 1 or 7, Part III)	3.12297 %
3.	Interest paid (from Part V)	698,785.12
4.	Policy and other contract liability requirements (Total of lines 2 and 3)	44,352.43
		743,137.55

PART II—ASSETS (Sec. 805(b)(4))

		1. Beginning of Taxable Year	2. End of Taxable Year	3. Mean of columns 1 and column 2
1.	Real estate	1,025,738.20	1,042,261.22	1,033,999.71
2.	Mortgages:			
	(a) Without service fees	3,485,485.50	3,376,927.90	3,431,206.70
	(b) With service fees	5,733,561.81	5,599,897.64	5,666,729.72
3.	Collateral loans	275,700.00	272,700.00	274,200.00
4.	Policy loans, including premium notes	2,043,403.98	2,233,301.02	2,138,352.50
5.	Corporate bonds	9,437,901.55	9,656,676.15	9,547,288.85
6.	Stocks	0	0	0
7.	Government obligations, etc. (Submit detailed schedule)	1,713,602.00	2,902,436.00	2,308,019.00
8.	Bank deposits, cash, etc.	987,738.07	1,363,781.39	1,175,760.73
9.	Other assets (Attach schedule)	1,282,546.89	1,211,936.32	1,248,241.61
10.	Totals	25,985,678.00	27,661,919.64	26,823,798.82

Adjusted under Section 806(b) (Attach schedule)

PART III—EARNINGS RATES (Sec. 805(b))

1.	Current earnings rate (line 14, Schedule A divided by line 10, column 3, Part II)	3.19731 %
2.	Earnings rate for first preceding year (Attach schedule)	3.16190 %
3.	Earnings rate for second preceding year (Attach schedule)	3.08326 %
4.	Earnings rate for third preceding year (Attach schedule)	3.07247 %
5.	Earnings rate for fourth preceding year (Attach schedule)	3.03923 %
6.	Total (lines 1–5)	15.61485
7.	Average earnings rate (See instructions)	3.12297 %

Page 3

1. Description	2. Country of Issue	3. Rate of Interest	4. Amount of Reserve (Schedule D)	5. Amount of Policy Loans (Schedule C)	6. Mean of ends of year	7. Interest Earned (Schedule A)
a. Life	Various	Various	20,548,850.00	2,796,250.00	23,167,700.00	693,939.36
b. Annuities	Various	Various	881,797.00	988,471.00	929,090.34	25,342.48
c. Supplementary Contracts	Various	Various	98,099.00	177,883.43	137,666.86	4,697.52
d. Dividend Accumulations	Various	Various	515,194.67	581,194.03	582,144.35	16,876.67
e. Other					23,761,601.55	740,876.03
f. Total						3.40420%

g. Average rate of interest computed to consolidate life insurance reserves (total of column 6 divided by total of column 7)

*Use insurance for group and other subdivisions — *Interest rates differ through subdivision

PART V—ADJUSTED LIFE INSURANCE RESERVES (See Instructions)

1. Mean of the reserves (col. 7, line 6, Part IV)		21,761,601.55
2. (a) Multiplied by that percentage which equals	100%	
(b) Increased by 10 times the average rate of interest assumed (from line 6, Part IV)	35.05%	
(c) Total	134.04200	
(d) Reduced by 10 times the adjusted reserves rate (from line 2, Part I, Schedule B)	31.22970	
(e) Line (c) less line (d)		102.81230 %
3. Adjusted life insurance reserves (line 1 multiplied by line 2(e))		22,375,659.00

PART VI—INTEREST PAID (See Instructions)

1. Interest on indebtedness	0
2. Amounts in the nature of interest	41,094.36
3. Discount on prepaid premiums	1,258.07
4. Total (interest paid (lines 1-3)	44,352.43

SCHEDULE G—TAXABLE INVESTMENT INCOME (See Instructions)

1. Policyholders' share (Sec. 804) (line 4, Part I, Sch. B divided by line 14, Sch. A) but not to exceed 100%			86.6491 %
2. Company's share			13.3509 %
3. Total			100.00 %

	1. Total	2. Deducted Policyholders' share (line 1 times col. 1)	3. Company's share (line 1 less col. 2)
	** EXCLUDED **		
4. Interest wholly tax-exempt (line 11(a), column 4, Schedule A)			
5. Interest partially tax-exempt (lines 10(a) and (c), column 4, Schedule A)			
6. (a) Dividends from line 2(a), Schedule A			
(b) Dividends from line 2(b), Schedule A			
(c) Dividends from line 2(c), Schedule A	0		
(d) Dividends from line 2(d), Schedule A	857,639.82	743,137.55	114,502.27
7. Other items of investment yield (line 14, Schedule A, less 4-6 above)	857,639.82	743,137.55	114,502.27
8. Total (Lines 4-7)			0
REDUCTIONS			0
9. Interest wholly tax-exempt (line 4, column 3)			
10. Interest partially tax-exempt (30/52 of line 5, column 3)			
11. Dividends received deduction:			
(a) 85% of dividends from line 6(a), column 3	0		
(b) 63.1115% of dividends from line 6(b), column 3	0		
(c) 85% of dividends from certain foreign corporations from line 6(c), column 3	0		
(d) Total, but not to exceed 85% of taxable investment income (line 14, Schedule C) computed without regard to this deduction			0
12. Small business deduction (10% of line 14, Schedule A, not to exceed $25,000)			25,000.00
13. Total (lines 9, 10, 11(d), and 12)			25,000.00
14. Taxable investment income (line 8 less line 13, but not less than zero)			89,502.27

175

EXHIBIT 2

	1. Total	2. Exclusive Participating Shareholders' Policyholders'	3. Company's share (Line 2 times Sch. C)
	** EXCLUDED **		
1. Policyholders' share (Sec. 8C (Line 3, Sec. E-1 divided by line 14, Sch. A), but not to exceed 10			
2. Company's share			
3. Total			
4. Interest wholly tax-exempt (line 1(a), column 4, Schedule A)			
5. Interest partially tax-exempt (lines 1(b) and (d), column 4, Schedule A)			
6. (a) Dividends from line 2(a), Schedule A			
(b) Dividends from line 2(b), Schedule A			
(c) Dividends from line 2(c), Schedule A			
(d) Dividends from line 2(d), Schedule A			
7. Other items of investment yield (line 14, Schedule A less 4-6 above)	857,639.82	781,540.32	76,099.50
8. Total (lines 4-7)	857,639.82	781,540.32	76,099.50
9. Gross premiums 6,319,787.11 Less: Return premiums, etc. 151,066.28			6,168,720.83
10. (a) Decrease in reserves (after adjustment under 810(d)) (Attach schedule)			
(b) Decrease in 811(b)(2) reserves (See line 3, Part IV, Schedule E-2)			662.22
11. Other amounts (Attach schedule)			6,245,382.55
12. Total (lines 8-11)			3,622,463.01
DEDUCTIONS			669,682.65
13. Death benefits, etc.			0
14. Increase in reserves (after reduction for investment yield under 810(d)) (Attach schedule)			0
15. Annuities by another person of liabilities under insurance, etc., contracts			0
16. Annuities wholly tax-exempt (line 4, column 3)			10,193.03
17. Interest partially tax-exempt (3%) of line 5, column 3)			25,000.00
18. Investment expenses, etc., not deducted on Schedule A (Attach schedule)			1,170.57
19. Small business deduction (10 percent of line 14, Schedule A, not to exceed $25,000)			5,487,946.59
20. Other deductions not deducted on Schedule A (Attach schedule)			
21. Total (lines 13-20)			
22. Dividends received deduction (See instructions)			
(a) 85% of dividends received from line 6(a), column 3	0		
(b) 62.115% of dividends from line 6(b), column 3	0		
(c) 85% of dividends from certain foreign corporations from line 6(c), column 3	0		
(d) Total, but not to exceed 85% of line 21			
23. Operations loss deduction (Attach schedule)			
24. Insurance deduction (lines 21-23)			
25. Plus: (a) Group life, accident, and he (Schedule E-2)			
(b) Certain nonparticipating ac (line 6-2)			
(c) Dividends to policyholders f			
26. Total deductions (line 24 plus			
27. Gain from operations (line 12 less line 26)			

Page 4

SCHEDULE D-1.—REQUIRED INTEREST [illegible] 809(a)(2))

	1. Rate	2. Beginning of Taxable Year	3. End of Taxable Year	4. Mean (Columns 2 plus 3)	5. Column 1 times column 4
1. 810(a)(1) Reserves (from line 5, column 8, Part IV, Schedule B)					740,676.03
2. 810(a)(3) Reserves	Various	730,213.00	705,412.00	717,844.00	21,691.29
3. 810(a)(4) Reserves	Various	490,726.00	524,839.00	512,782.00	17,849.16
4. 810(a)(5) Reserves	Various	50,218.21	62,167.01	56,192.61	1,123.84
5. Required interest (Total, lines 1-4)					781,540.32

SCHEDULE D-2.—PART I—LIMITATION ON LINE 25, SCHEDULE E DEDUCTION (Sec. 809(f))

1. Statutory amount			250,000
2. (a) From line 12, Schedule E	6,245,382.55		
(b) Less: Tentative deduction, line 24, Schedule E	5,487,946.59		
3. Gain from operations without regard to line 25, Schedule E	757,435.96		
4. Less: Taxable investment income (line 14, Schedule C)	89,502.27		667,933.69
5. Excess of line 3 over line 4 (but not less than zero)			917,933.69
6. Maximum possible deduction for line 25, Schedule E (line 1 plus line 5)			47,749.74
7. Deduction for group life, accident, and health insurance (Part II) (Not in excess of line 6)			870,183.95
8. Maximum deduction for certain nonparticipating contracts (line 6 less line 7)			127,116.96
9. Deduction for certain nonparticipating contracts (Part III) (Not in excess of line 8)			343,066.99
10. Maximum deduction for dividends to policyholders (line 8 less line 9)			453,368.22
11. Deduction for dividends to policyholders (Part IV) (Not in excess of line 10)			

PART II—GROUP LIFE, ACCIDENT, AND HEALTH INSURANCE (Sec. 809(d)(6))

1. Net premiums			2,387,487.15
2. Multiplied by			2%
3. Tentative deduction			47,749.74

PART III—CERTAIN NONPARTICIPATING CONTRACTS (Sec. 809(d)(5))

1. (a) Reserve at the end of the taxable year	20,550,115.02		
(b) Reserve at the beginning of the taxable year	19,278,945.36		
(c) Increase (if the difference is negative, enter "0")	1,271,169.66		
(d) Multiplied by	10%		127,116.96
2. (a) Net premiums	3,065,676.34		
(b) Multiplied by	3%		91,970.29
3. Tentative deduction—the greater of line 1 or line 2			127,116.96

PART IV—DIVIDENDS TO POLICYHOLDERS (Sec. 809(d)(3))

1. Dividends paid to policyholders			444,456.63
2. (a) Increased by the excess of (1) over (2):			
(1) Reserve as of the end of the taxable year	204,949.47		8,911.59
(2) Reserve as of the end of the preceding taxable year	196,037.88		
OR			
(b) Decreased by the excess of (1) over (2):			
(1) Reserve as of the end of the preceding taxable year			
(2) Reserve as of the end of the taxable year			453,368.22
3. If positive, enter on line 11, Schedule E-2; if negative, enter on line 10(b), Schedule E			

177

EXHIBIT 2

SCHEDULE F.—SHAREHOLDERS SURPLUS ACCOUNT (Sec. 815(b))

Page 4a

1. Balance as of January 1, 1958			zero 109,351.66
2. Life insurance company taxable income			0
3. Partially tax-exempt interest deduction (20/52 of item 10(a) and (c), column 4, Schedule A)			
4. Dividends received deduction:			
(a) 85% of dividends received from line 21(a), Schedule A		0	
(b) 62.115% of dividends received from line 21(b), Schedule A		0	
(c) 85% of dividends received from certain foreign corporations		0	
(d) Total, but not to exceed 85% of line 12 less line 21, Schedule E			0
5. Interest wholly exempt from tax (line 11(a), column 4, Schedule A)			36,637.79
6. Small business deduction (line 19, Schedule D)			25,000.00
7. Total (lines 1–6)			170,989.45
8. Less Tax Liability for 1958 under 802(a)			54,362.86
9. Excess of line 7 over line 8			119,626.59
10. Less Distributions in 1959 (But to exceed line 9)			70,000.00
11. Balance as of December 31, 1959 (line 9 less line 10)			49,626.59

SCHEDULE H.—LIMITATION OF INVESTMENT EXPENSE DEDUCTION (Schedule H need not be filed as if no deduction is claimed for any general expenses that are allocated to investment income.)

1. Means of the assets for the taxable year (line 10, column 3, Part II, Schedule B)		26,823,798.82
2. One-fourth of 1% of the means of the assets (line 1)		67,059.50
3. Mortgage service fees		28,965.05
4. The greater of (a) or (b):		
(a) (i) Investment yield computed without regard to investment expenses	1,147,641.26	
(ii) Three and three-fourths percent of line 1	1,005,892.46	
(iii) Excess (line (i) over line (ii))	141,748.80	
(b) One-fourth of line (a)(ii)	35,437.20	
(c) Reduced by mortgage service fees (line 3)	28,965.05	
(d) Less (c) (not less than (b))	6,472.15	
(e) One-fourth of 1% of the amount on line 2(a), column 2, Part II, Schedule B	8,578.02	8,578.02
5. Limit on deduction for investment expenses (Total lines 2–4)		104,602.57

M. Did you file with the ...rict Director a copy of the annual statement for the preceding year as required by General Instruction K?
☒ Yes ☐ No If "Yes," state office in which filed.
Oklahoma City, Oklahoma

N. Did you, at any time during the taxable year, own directly or indirectly 50% or more of the voting stock of a domestic corporation?
☐ Yes ☒ No

O. If a copy of the annual statement does not accompany this return, state why the statement is not attached.
Filed with original return

P. Did any corporation, individual, partnership, trust, or association at any time during the taxable year own directly or indirectly 50% or more of your voting stock?
☐ Yes ☒ No
If answer is "Yes," see instruction N.

Q. Did you at any time during the taxable year own directly or indirectly any stock of a foreign corporation? (If "Yes," attach statement required by General Instruction I.)
☐ Yes ☒ No

178

EXHIBIT 2

SCHEDULE G.—POLICYHOLDERS SURPLUS ACCOUNT (Sec. 815(a))

			Page 4b amo
1. Balance as of the beginning of the taxable year			
2. Add: (a) 50 percent of the excess, if any, of the gain from operations over the taxable investment income (line 2, page 1)		19,609.39 127,116.96	
(b) The deduction for certain nonparticipating contracts (line 25(b), Schedule D)			
(c) The deduction for group life, accident, and health insurance (line 25(a), Schedule D)		47,749.74	194,716.09
3. Total (line 1 plus line 2)			194,716.09
4. Less: (a) Actual distributions only to excess of line 10, Schedule F	0		
(b) Tax increase on 4(a) by reason of 802(b)(3)	0		
(c) Amounts treated as distributions (See instructions)	0		
(d) Tax increase on 4(c) by reason of 802(b)(3)	0		
(e) Subtractions required under 815(d)	0		
5. Total of lines 4(a) - (d) (Not to exceed line 3) (Enter here and on line 3, page 1)			0
6. Balance as of the end of the year (line 3 less line 5)			194,716.09

EXHIBIT 2

IN UNITED STATES DISTRICT COURT

Pg 1

Form 1120 L — U.S. LIFE INSURANCE COMPANY INCOME TAX RETURN FOR CALENDAR YEAR 1958 — 1958

Do not write in space below

PLEASE TYPE OR PRINT PLAINLY

Plaintiff's Exhibit 9

Name: The Atlas Life Insurance Company

Address: 415 South Boston Avenue, Tulsa 3, Oklahoma

a. Date and place incorporated: September 25, 1918 Oklahoma

b. Employer's identification number: 01-05132

c. Amount of total dependable income: 430,508.05

d. Amount of total dependable income claimed for current year: 35,405.55

e. Amount of total investment deductions as defined in Sec. 804(a)(2): Not applicable to this company.

f. Is this a consolidated return? (If "Yes," see Instruction 5L) ☐ Yes ☒ No

g. Do you have any subsidiary essentially noninsurance? (If "Yes," see Instruction 5M) ☐ Yes ☒ No

h. Are you a mutual or mutual benefit insurance company, or mutual marine, to the computation of taxable income under section 821(a)(2)? (If "Yes," see Instruction 5N) ☐ Yes ☒ No

i. Did you file Forms 1096 and 1099 for the calendar year in connection with taxable dividends? (See Statement of Information 5L) ☒ Yes ☐ No

j. Did you file Forms 1096 and 1099 for the calendar year in connection with other payments? (See Statement of Information 5L) ☒ Yes ☐ No

☐ Yes ☒ No

LIFE INSURANCE COMPANY TAXABLE INCOME

1. (a) The taxable investment income (Schedule C)	950	101,190.77	101,190.77	950
(b) The gain from operations (Schedule D)	954	162,184.34	30,496.79	407
(c) The smaller of (a) or (b)				
2. 50 percent of the excess, if any, of 1(a) over 1(c)			131,687.56	957
3. Life insurance company taxable income (Total lines 1(c) and 2)				

COMPUTATION OF TAX DUE OR REFUND

4. If amount of line 3 is:				
(a) Not over $25,000— Enter 30 percent of line 3 (22 percent if a consolidated return)				
(b) Over $25,000— Enter $7,500 and 52 percent of line 3 (34 percent if a consolidated return)	964	68,477.53 / 8,500.00	62,977.53	344
Subtract $25,000, and enter difference				
5. Less: Credit allowed a domestic corporation for income taxes paid to a foreign country or United States possession (Submit Form 1118)			0	
6. Total income tax (line 4 less line 5)			62,977.53	344
7. Credits for amounts paid on 1958 income tax: (a) Tax paid with applications for extension of time to file		64,055.79	64,055.79	
(b) Payments and credits on 1958 Declaration of Estimated Tax				
8. If tax (line 6) is larger than payments (line 7), the balance is TAX DUE. Enter such balance here →			1,078.26	344
9. If payments (line 7) are larger than tax (line 6) Enter the OVERPAYMENT here →				
10. Enter amount of line 9 you want Credited on 1959 estimated tax				
Refunded		1,078.26	344	

SIGNATURE AND VERIFICATION (See Instruction E)

I declare under the penalties of perjury that this return (including any accompanying schedules and statements) has been examined by me and to the best of my knowledge and belief is a true, correct, and complete return. If the return is prepared by a person other than the taxpayer, his declaration is based on all the information relating to the matters required to be reported in the return of which he has knowledge.

CORPORATE SEAL

(Date) (Signature of officer) (Title)

(Date) (Individual or firm signature) (Address)

107

EXHIBIT 1-T.

PX 9

FORM 1120 L—1958

p2

Page 2

SCHEDULE A.—INVESTMENT YIELD (See Instructions)

Line and Schedule No.	Gross Investment Income (Section 804(b))	1. Interest Earned	2. Accrual of Discount	3. Amortization of Premium	4. Total (In the Case of Lines 1 thru Columns 1 plus Columns 2 plus Columns 3)
1.	Interest on:	35,796.15	1,627.00	786.36	36,637.79
	(a) Wholly exempt obligations. (Attach schedule)	0	0	0	0
	(b) United States Savings Bonds and Treasury Bonds owned in excess of the aggregate limit of $5,000 owned prior to March 1, 1941	0	0	0	0
	(c) Obligations issued on or after March 1, 1941, by the United States or any agency or instrumentality thereof. (Attach schedule)	46,445.34	25.00	11.00	46,459.34
	(d) Other	892,215.66	6,309.98	2,953.05	892,572.61 /SSB
	Totals	974,457.17	7,961.98	6,749.41	975,669.74 /SSB
2.	Dividends on stock of:				0
	(a) Domestic corporations subject to taxation under Chapter 1, I.R.C.				0
	(b) Certain preferred stock of public utilities taxable under Chapter 1, I.R.C.				0
	(c) Foreign corporations				0
	(d) Other corporations				164,995.28
3.	Rents. (Attach schedule)				0
4.	Royalties. (Attach schedule)				0
5.	Leases, terminations, etc.				0
6.	Gross income from trade or business other than insurance business. (Attach schedule)				1,140,665.02 /SSB
7.	GROSS INVESTMENT INCOME (total lines 1-6)				
	Deductions (Section 804(a))				
8.	Investment expenses. (Attach schedule) (See Schedule H)				104,602.57
9.	Real estate expenses. (Attach schedule)				121,534.99
10.	Depreciation. (Attach schedule)				19,249.85
11.	Depletion of mines, oil and gas wells, timber, etc. (Attach schedule)				0
12.	Trade or business deductions as provided in 804(a)(3) (Attach schedule)				0
13.	Total deductions (lines 8-12)				245,387.41
14.	INVESTMENT YIELD (line 7 less line 13)				895,277.61 /SSB

SCHEDULE B.—PART I—POLICY AND OTHER CONTRACT LIABILITY REQUIREMENTS (Sec. 806(a)) (See Instructions.)

1. Adjusted life insurance reserves (from Part V)	2.096	22,082,869.23	719,349.91 SSB
2. Multiplied by the adjusted reserves rate (Lesser of lines 1 or 7, Part III)	.032740	3.257502%	4,352.43
3. Interest paid (from Part VI)			76,702.34 SSB
4. Policy and other contract liability requirements (Total of lines 2 and 3)			

PART II—ASSETS (Sec. 806(b)(4))

	1. Beginning of Taxable Year	2. End of Taxable Year	3. Mean of columns 1 and column 2
1. Real estate	1,025,738.20	1,042,261.22	1,033,999.71
2. Mortgages			
(a) Without service fees	3,485,485.50	3,376,927.90	3,431,206.70
(b) With service fees	5,733,561.81	5,599,897.64	5,666,729.72
3. Collateral loans	275,700.00	272,700.00	274,200.00
4. Policy loans, including premium notes	2,043,403.98	2,233,301.02	2,138,352.50
5. Corporate bonds	9,437,901.55	9,656,679.15	9,547,288.85
6. Stocks	0	0	0
7. Government obligations, etc. (Submit detailed schedule)	1,713,602.00	2,902,436.00	2,308,019.00
8. Bank deposits, cash, etc.	987,738.07	1,363,783.39	1,175,760.73
9. Other assets (Attach schedule)	1,282,546.89	1,213,930.32	1,248,241.61
10. Totals	25,985,678.00	27,661,919.64	26,823,798.82

*Adjusted under Section 806(b)(4) (Attach schedule)

PART III—EARNINGS RATES (Sec. 806(b))

1. Current earnings rate (line 14, Schedule A divided by line 10, column 3, Part II)	.033762	3.33762
2. Earnings rate for first preceding year (Attach schedule)	.031406	3.31406
3. Earnings rate for second preceding year (Attach schedule)	.032416	3.20416
4. Earnings rate for third preceding year (Attach schedule)	.032210	3.22957
5. Earnings rate for fourth preceding year (Attach schedule)	.032957	16.28754
6. Total (lines 1-5)	.162754	3.257502
7. Average earnings rate (See Instructions)	.032740	

EXHIBIT 1-T

Page 3

PART IV—AVERAGE INTEREST RATE ASSUMED (Sec. 809(d)(2))

1. Nature of Reserve (Life, Annuity, etc.)	2. Assumed Mortality or Morbidity Table	3. Assumed Interest Rate	4. Method of Computation (Reserve Bases, etc.)	5. Amount of Reserve at Beginning of Taxable Year	6. Amount of Reserve at End of Taxable Year	7. Mean of Columns 5 and 6	8. Column 7 times Column 3
1. Life	V a r i o u s			19,548,850.00	20,786,550.00	20,167,700.00	693,959.36
2. Annuities	V a r i o u s			893,707.00	984,473.68	939,090.34	25,342.48
3. SCLIC	V a r i o u s			98,050.26	177,283.43	137,666.86	4,697.52
4. Other	V a r i o u s			515,154.61	583,134.01	549,144.35	16,876.67
5. Totals						21,793,601.55	740,876.03

6. Average rate of interest assumed in computing life insurance reserves (total of column 8 divided by total of column 7) ..... 3.40420 %

*Adjusted under 809(d) (5) with subsidiary

**See instructions for 809(d) and (f) adjustments

PART V—ADJUSTED LIFE INSURANCE RESERVES (Sec. 809(d)(1))

1. Mean of the reserves (col. 7, line 6, Part IV)		21,761,601.55
2. (a) Multiplied by that percentage which equals	100%	
(b) Increased by 10 times the average rate of interest assumed (from line 6, Part IV)	10.0342	
(c) Total	134.0342	
(d) Reduced by 10 times the adjusted reserve rate (from line 2, Part I, Schedule H) .04440	32.5702	101.46698 %
(e) Line (d) less line (d)	.04440	22,082,869.23
3. Adjusted life insurance reserves (col. 1 multiplied by line 2(e))		

PART VI—INTEREST PAID (Sec. 809(d))

1. Interest on indebtedness	0
2. Amounts in the nature of interest	43,094.46
3. Discount on prepaid premiums	1,258.97
4. Total interest paid (lines 1-3)	44,352.43

SCHEDULE C—TAXABLE INVESTMENT INCOME (See Instructions)

1. Policyholders' share (Sec. 809) (line 4, Part I, Sch. B divided by line 14, Sch. A) but not to exceed 100% .84437		85.30341 %
2. Company's share .84437		14.69659 %
3. Total	100	%

	1. Total	2. Policyholders' share (line 1 times col. 1)	3. Company's share (line 1 times col. 1)
4. Interest wholly tax-exempt (line 11(a), column 4, Schedule A)	36,637.79	31,253.28	5,384.51
5. Interest partially tax-exempt (lines 10(a) and (d), column 4, Schedule A)	0	0	0
6. (a) Dividends from line 2(d), Schedule A	0	0	0
(b) Dividends from line 2(e), Schedule A	0	0	0
(c) Dividends from line 2(f), Schedule A	0	0	0
(d) Dividends from line 3(d), Schedule A	0	0	0
7. Other items of investment yield (line 14, Schedule A, lines 4-6 above)	858,639.82	732,449.05	126,190.77
8. Total (Lines 4-7)	895,277.61	763,702.33	131,575.28
REDUCTIONS			
9. Interest wholly tax-exempt (line 4, column 3)			5,384.51
10. Interest partially tax-exempt (85/85 of line 5, column 3)			0
11. Dividends received deductions:			
(a) 85% of dividends from line 6(a), column 3	0		
(b) 62.1115% of dividends from line 6(b), column 3	0		
(c) 85% of dividends from certain foreign corporations from line 6(c), column 3	0		
(d) Total, but not to exceed 85% of taxable investment income (line 14, Schedule C) computed without regard to this deduction			0
12. Small business deduction (10% of line 14, Schedule A, not to exceed $25,000)			25,000.00
13. Total (lines 9, 10, 11(d), and 12)			30,384.51
14. Taxable investment income (line 8 less line 13, but not less than zero)			101,190.77

EXHIBIT 1-T

SCHEDULE E—GAIN AND LOSS FROM OPERATIONS (See Instructions)

1. Policyholders' share (Sec. 809) (Line X, Sch. K-1 divided by line 14, Sch. A), but not to exceed 100%			87.29586 %
2. Company's share			12.70414 %
3. Total			100 %
	1. Total	2. Exclusive Policyholders' share (Line 1 minus col. 3)	3. Company's share (Line 1 minus col. 2)
4. Interest wholly tax-exempt (line 1(a), column 4, Schedule A)	36,637.79	31,983.27	4,654.52
5. Interest partially tax-exempt (lines 1(b) and (d), column 4, Schedule A)	0	0	0
6. (a) Dividends from line 2(a), Schedule A	0	0	0
(b) Dividends from line 2(b), Schedule A	0	0	0
(c) Dividends from line 2(c), Schedule A	0	0	0
(d) Dividends from line 2(d), Schedule A	0	0	0
7. Other items of investment yield (line 14, Schedule A less 4-6 above)	858,639.82	749,557.02	109,082.80
8. Total (lines 4-7)	895,277.61	781,540.29	113,737.32
9. Gross premiums 6,319,787.11 Less Return premiums, etc. 151,086.28			6,168,700.83
10. (a) Decrease in reserves (after adjustment under §810(d)) (Attach schedule)			0
(b) Decrease in §810(c)(2) reserves (See line 2, Part IV, Schedule E-2)			0
11. Other accounts (Attach schedule)			582.22
12. Total (lines 9-11)			6,283,020.37
DEDUCTIONS			
13. Death benefits, etc.			3,612,468.01
14. Increase in reserves (after reduction for investment yield under §810(d)) (Attach schedule)			669,621.65
15. Assumption by another person of liabilities under insurance, etc., contracts			0
16. Interest wholly tax-exempt (line 4, column 3)			4,654.52
17. Interest partially tax-exempt (85/85 of line 5, column 3)			0
18. Interest paid or accrued on indebtedness (Attach schedule)			10,183.03
19. Investment expenses, etc., not deducted on Schedule A (Attach schedule)			25,000.00
20. Small business deduction (10 percent of line 14, Schedule A, not to exceed $25,000)			1,170,673.90
21. Other deductions not deducted on Schedule A (Attach schedule)			5,492,601.11
22. Total (lines 13-20)			
23. Dividends received deduction (See instructions):			
(a) 85% of dividends received (line 6(a), column 3)	0		
(b) 42.1175% of dividends received (line 6(b), column 3)	0		
(c) 85% of dividends from certain foreign corporations (line 6(c), column 3)	0		
(d) Total, but not to exceed 85% of the amount, if any, of line 12 over line 21			0
24. Operations loss deduction (Attach schedule)			0
25. Tentative deduction (lines 21-23)			5,492,601.11
26. Total (a) Group life, accident, and health insurance (line 7, Part I, Schedule E-2)			47,749.74
(b) Certain nonparticipating contracts (line 9, Part I, Schedule E-2)			127,116.56
(c) Dividends to policyholders (line 11, Part I, Schedule E-2)			453,368.22
(d) Total deductions (line 24 plus line 25)			6,120,836.03
27. Gain from operations (line 12 less line 26)			162,184.34

EXHIBIT 1-T

F5

Page 4

SCHEDULE S-1.—REQUIRED INTEREST (Sec. 809(a)(2))

	1. Rate	2. Beginning of Taxable Year	3. End of Taxable Year	4. Mean (Column 2 plus 3)	5. Column 1 times column 4
1. 810(d)(1) Reserves from line 3, column 8, Part IV, Schedule B					740,876.03
2. 810(d)(2) Reserves	Various	730,213.00	705,412.00	717,844.00	21,691.29
3. 810(d)(4) Reserves	Various	490,726.00	534,839.00	512,782.00	17,849.16
4. 810(d)(5) Reserves	Various	50,218.21	62,167.01	56,192.61	1,123.84
5. Required interest (Total, lines 1-4)					781,540.32

SCHEDULE S-2.—PART I—LIMITATION ON LINE 33, SCHEDULE E DEDUCTION (Sec. 809(c))

1. Statutory amount			250 000
2. (a) From line 12, Schedule E	AAC	6,283,020.37	
(b) Less: Tentative deduction, line 34, Schedule E	AK	5,492,601.11	
3. Gain from operations without regard to line 25, Schedule E	TAX	790,419.26	
4. Less: Taxable investment income (line 14, Schedule C)	SUB	101,190.77	689,228.49 SUB
5. Excess of line 3 over line 4 (but not less than zero)			939,228.49 SUB
6. Maximum possible deduction for line 25, Schedule E (line 1 plus line 5)			47,749.74
7. Deduction for group life, accident, and health insurance (Part II) (Not in excess of line 6)			891,478.75 SUB
8. Maximum deduction for certain nonparticipating contracts (line 6 less line 7)			127,116.96
9. Deduction for certain nonparticipating contracts (Part III) (Not in excess of line 8)			764,361.79 SUB
10. Maximum deduction for dividends to policyholders (line 9 less line 9)			453,368.22
11. Deduction for dividends to policyholders (Part IV) (Not in excess of line 10)			

PART II—GROUP LIFE, ACCIDENT, AND HEALTH INSURANCE (Sec. 809(d)(8))

1. Net premiums		2,387,487.15
2. Multiplied by		2%
3. Tentative deduction		47,749.74

PART III—CERTAIN NONPARTICIPATING CONTRACTS (Sec. 809(d)(5))

1. (a) Reserve at the end of the taxable year		20,550,115.02	
(b) Reserve at the beginning of the taxable year		19,278,945.38	
(c) Increase (If the difference is negative, enter "0")		1,271,169.64	
(d) Multiplied by		10%	127,116.96
2. (a) Net premiums		3,065,676.34	
(b) Multiplied by		3%	91,970.29
3. Tentative deduction—the greater of line 1 or line 2			127,116.96

PART IV—DIVIDENDS TO POLICYHOLDERS (Sec. 809(d)(3))

1. Dividends paid to policyholders			444,456.63
2. (a) Increased by the excess of (1) over (2):			
(1) Reserve as of the end of the taxable year		204,949.47	
(2) Reserve as of the end of the preceding taxable year		196,037.88	8,911.59
OR			
(b) Decreased by the excess of (2) over (2):			
(1) Reserve as of the end of the preceding taxable year			
(2) Reserve as of the end of the taxable year			
3. If positive, enter on line 11, Schedule S-2; if negative, enter on line 10(b), Schedule E			453,368.22

101

EXHIBIT 1-T

SCHEDULE F.—SHAREHOLDERS SURPLUS ACCOUNT (Sec. 815(b))

Page 4a

1. Balance as of January 1, 1958			31,687.56
2. Life insurance company taxable income			0
3. Partially tax-exempt interest deduction (2)(B) of lines 1(b) and (c), column 4, Schedule A)			
4. Dividends received deduction:			
(a) 85% of dividends received from line 2(a), Schedule A		0	
(b) 62.115% of dividends received from line 2(b), Schedule A		0	
(c) 85% of dividends received from certain foreign corporations		0	
(d) Total, but not to exceed 85% of line 12 less line 21, Schedule E			0
5. Interest wholly exempt from tax (line 1(c), column 4, Schedule A)			36,637.79
6. Small business deduction (line 19, Schedule D)			25,000.00
7. Total (lines 1-6)			193,325.35
8. Less: Tax liability for 1958 under 802(a)			62,977.53
9. Excess of line 7 over line 8			130,347.82
10. Less: Distributions in 1958 (not to exceed line 9)			70,000.00
11. Balance as of December 31, 1958 (line 9 less line 10)			60,347.82

SCHEDULE H.—LIMITATION OF INVESTMENT EXPENSE DEDUCTION (Schedule H need not be filed in if no deduction is claimed or any interest expenses that are allocated to investment income.)

1. Mean of the assets for the taxable year (line 10, column 3, Part II, Schedule B)			26,831,799.82
2. One-fourth of 1% of the mean of the assets (line 1)			67,059.50
3. Mortgage service fees			28,965.05
4. The greater of (a) or (b):			
(a) If investment yield computed without regard to investment expenses	1666	1,148,641.26	
(1) Three and three-fourths percent of line 1	1666	1,005,892.48	
(2) Excess (line (1) over line (a))		142,748.80	
(3) One-fourth of line (2)		35,687.20	
(4) Reduced by mortgage service fees (line 3)	446	28,965.05	
(5) Line (4) less line (4)		6,722.15	
(b) One-fourth of 1% of the amount on line 2(a), column 3, Part II, Schedule B		8,578.02	8,578.02
5. Limit on deduction for investment expenses (Total lines 2-4)			104,602.57

6. Did you, at any time during the taxable year own, directly or indirectly 50% or more of the voting stock of a domestic corporation?
☐ Yes ☒ No

7(a) Any corporation, individual, partnership, trust, or association at any time during the taxable year, own directly or indirectly 50% or more of your voting stock?
☐ Yes ☒ No
If either answer is "Yes," see Instruction H.

(b) Did you at any time during the taxable year own directly or indirectly any stock of a foreign corporation? If "Yes," attach statement required by General Instruction I.)
☐ Yes ☒ No

8. Did you file with the District Director a copy of the annual statement for the preceding year as required by General Instruction K?
☒ Yes ☐ No If "Yes," state office in which filed.
Oklahoma City, Oklahoma

9. If a copy of the annual statement does not accompany this return, state why the statement is not attached.
Filed with original return

192

EXHIBIT 1-T

F7

SCHEDULE G.—POLICYHOLDERS SURPLUS ACCOUNT (Sec. 815(a)) Page 4b

			zero
1. Balance as of the beginning of the taxable year			
2. Add: (a) 50 percent of the excess, if any, of the gain from operations over the taxable investment income (line 2, page 1)	30,496.79		
	127,116.96		
(b) The deduction for certain nonparticipating contracts (line 25(a), Schedule D)	47,749.74		205,363.49 407
(c) The deduction for group life, accident, and health insurance (line 25(c), Schedule D)			205,363.49 407
3. Total (line 1 plus line 2)			205,363.49 407
4. Less: (a) Actual distributions only in excess of line 10, Schedule F		0	
(b) Tax increase on 4(a) by reason of 802(b)(3)		0	
(c) Amounts treated as distributions (See instructions)		0	
(d) Tax increase on 4(c) by reason of 802(b)(3)		0	
(e) Subtractions required under 815(d)		0	
5. Total of lines 4(a)-(d) (Not to exceed line 3) (Enter here and on line 3, page 1)			0
6. Balance as of the end of the year (line 3 less line 5)			205,363.49 407

IN UNITED STATES DISTRICT COURT for the northern District, Oklahoma

Plaintiff's Exhibit 10

FORM 1120 L — U.S. LIFE INSURANCE COMPANY INCOME TAX RETURN FOR CALENDAR YEAR 1953 — 1953

U.S. Treasury Department, Internal Revenue Service

PLEASE TYPE OR PRINT PLAINLY

Name: The Atlas Life Insurance Company

Address (number, street, city or town, postal zone number, State): 415 South Boston Avenue, Tulsa 3, Oklahoma

a. Date and place incorporated: September 25, 1918 Oklahoma

b. Employer's identification number: 01-05132

c. Amount of total dividends claimed for current year: 35,485.55

d. Amount of total insurance liabilities as defined in Sec. 801(b)(2): Not applicable to this company

e. Amount of total depreciable assets: 430,508.05

f. Is this a consolidated return? (If "Yes," see instruction 16.) ☐ Yes ☒ No

g. Do you have any variable annuity contracts outstanding? (If "Yes," see section 806 (g).) ☐ Yes ☒ No

h. Are you a mutual or fraternal benefit organization, or an agent directly in the mutual interest of, or in the administration of mutual business? (If "Yes," see section 809.) ☐ Yes ☒ No

i. Did you file Forms 1096 and 1099 for the calendar year in connection with taxable dividends? (See General Instruction 14.) ☒ Yes ☐ No

j. Did you file Forms 1096 and 1099 for the calendar year in connection with other payments? (See General Instruction 14.) ☒ Yes ☐ No

LIFE INSURANCE COMPANY TAXABLE INCOME

1. (a) The taxable investment income (Schedule C)	493	101,043.81		
(b) The gain (loss) from operations (Schedule D)	517	162,057.30	101,043.81	493
(c) The smaller of (a) or (b)			30,506.75	497
2. 50 percent of the excess, if any, of 1(b) over 1(a)			131,550.54	660
3. Life insurance company taxable income (Total lines 1(c) and 2)				

COMPUTATION OF TAX DUE OR REFUND

4. If amount of line 3 is: (a) Not over $25,000— Enter 30 percent of line 3 (22 percent if a consolidated return)				
(b) Over $25,000— Enter $3 percent of line 3 ($4 percent if a consolidated return)	491	68,406.29	62,906.29	491
Subtract $5,500, and enter difference		5,500.00		
5. Less: Credit allowed a domestic corporation for income taxes paid to a foreign country or United States possession (Submit Form 1118)			0	
6. Total income tax (line 4 less line 5)			62,906.29	491
7. Credits for amounts paid on 1953 income tax: (a) Tax paid with application for extension of time in which to file		64,055.79		
(b) Payments and credits on 1953 Declaration of Estimated Tax			64,055.79	
8. If tax (line 6) is larger than payments (line 7), the balance is TAX DUE. Enter such balance here →				
9. If payments (line 7) are larger than tax (line 6) Enter the OVERPAYMENT here →			1,149.50	491
10. Enter amount of line 9 you want: Credited on 1954 estimated tax				
Refunded		1,149.50	491	

SIGNATURE AND VERIFICATION (See Instruction E)

I declare under the penalties of perjury that this return (including any accompanying schedules and statements) has been examined by me, and to the best of my knowledge and belief is a true, correct, and complete return. If the return is prepared by a person other than the taxpayer, his declaration is based on all the information relating to the matter reported in the return of which he has knowledge.

CORPORATE SEAL

(Date) (Signature of officer) (Title)

(Date) (Individual or firm signature) (Address)

194

EXHIBIT 1-49 PX 10 FORM 1120 L—1953

Page 3

SCHEDULE A.—INVESTMENT YIELD (See Instructions)

Line no.	Gross Investment Income (Section 804(b))	1. Income Received	2. Amount of Dividends	3. Amortization of Premiums	4. Total (Sum of Cols. 1 and 2 less Col. 3)
1.	Interest on:				
	(a) Bonds (except those listed in item 2 below)	36,796.15	1,627.00	785.36	37,637.79
	(b) Bonds (except those listed in item 2 below) which are exempt from tax under section 501(c)	0	0	0	0
	(c) Obligations of States and political subdivisions, the interest on which is excluded from gross income under section 103	0	0	0	0
	(d) Obligations of the United States, its agencies and instrumentalities	46,445.34	22.00	14.00	46,459.34
	(e) Mortgage loans	891,215.68	6,309.98	3,253.05	891,272.61
	(f) Other				975,669.74
	(g) Loans, rents, mortgages, bank deposits, bonds, debentures, etc.	974,457.17	7,961.98	6,749.41	
	Totals				0
2.	Dividends on stock of:				
	(a) Domestic corporations subject to taxation under Chapter 1, I.R.C.				0
	(b) Certain preferred stock of public utilities taxable under Chapter 1, I.R.C.				0
	(c) Foreign corporations				164,995.28
	(d) Other corporations				0
3.	Rents. (Attach schedule)				0
4.	Royalties. (Attach schedule)				0
5.	Leases, investments, etc.				1,140,665.02
6.	Gross income from trade or business other than insurance business. (Attach schedule)				
7.	GROSS INVESTMENT INCOME (Add lines 1-6)				104,602.57
	Deductions (Section 804(c))				121,534.99
8.	Investment expenses. (Attach schedule) (See Schedule H)				19,249.85
9.	Real estate expenses. (Attach schedule)				0
10.	Depreciation. (Attach schedule)				0
11.	Depletion of mines, oil and gas wells, timber, etc. (Attach schedule)				245,387.41
12.	Trade or business deductions as provided in 804(c)(3) (Attach schedule)				895,277.61
13.	Total deductions (lines 8-12)				
14.	INVESTMENT YIELD (See 756 line 1-2)				

SCHEDULE B.—PART I.—POLICY AND OTHER CONTRACT LIABILITY REQUIREMENTS (Sec. 808(a)) (See Instructions)

1.	Adjusted life insurance reserves (from Part V)	22,082,869.23	
2.	Multiplied by the adjusted reserves rate (lesser of lines 1 or 7, Part III)	3.257502%	719,349.91
3.	Interest paid (from Part VI)		44,352.43
4.	Policy and other contract liability requirements (Total of lines 2 and 3)		763,702.34

PART II—ASSETS (Sec. 808(b)(1))

		1. Beginning of Taxable Year	2. End of Taxable Year	3. Mean of column 1 and column 2
1.	Real estate	1,025,738.20	1,042,261.22	1,033,999.71
2.	Mortgages:			
	(a) Without service fees	3,485,485.50	3,376,927.90	3,431,206.70
	(b) With service fees	5,733,561.81	5,599,897.63	5,666,729.72
3.	Collateral loans	275,700.00	272,700.00	274,200.00
4.	Policy loans, including premium notes	2,043,403.98	2,233,301.02	2,138,352.50
5.	Corporate bonds	9,437,901.55	9,659,676.15	9,548,788.85
6.	Stocks	0	0	0
7.	Government obligations, etc. (Submit detailed schedule)	1,733,602.00	2,902,436.00	2,308,019.00
8.	Bank deposits, cash, etc.	987,738.07	1,363,781.39	1,175,760.73
9.	Other assets (Attach schedule)	1,282,546.89	1,213,936.32	1,248,241.61
10.	Totals	25,985,678.00	27,661,919.64	26,823,798.82

*Adjusted under Section 806(a) (Attach schedule)

PART III—EARNINGS RATES (Sec. 808(b))

1.	Current earnings rate (line 14, Schedule A divided by line 10, column 3, Part II)	3.33762
2.	Earnings rate for first preceding year (Attach schedule)	3.31400
3.	Earnings rate for second preceding year (Attach schedule)	3.30410
4.	Earnings rate for third preceding year (Attach schedule)	3.20210
5.	Earnings rate for fourth preceding year (Attach schedule)	3.22957
6.	Total (lines 1-5)	16.38731
7.	Average earnings rate (See instructions)	3.257502%

EXHIBIT 1-TX

Page 3

PART IV—AVERAGE INTEREST RATE ASSUMED (Sec. 809(a)(2))

1. Nature of Reserve (Life, Annuity, Etc.)	2. Assumed Mortality or Morbidity Table	3. Assumed Interest Rate	4. Method of Computation (Attach Statement and Etc.)	5. Amount of Reserve at Beginning of Taxable Year	6. Amount of Reserve at End of Taxable Year	7. Mean of Columns 5 and 6	8. Interest Required (Multiply Column 7 by Column 3)
1. Life	Various	Various	Various	19,548,850,00	20,786,550,00	20,167,700.00	693,959.35
2. Annuities	Various	Various	Various	893,707.00	924,473.68	909,090.34	25,342.48
3. SCLTC	Various	Various	Various	98,050.28	177,283.43	137,666.86	4,697.52
4. Other	Various	Various	Various	515,154.67	583,134.01	56,144.35	16,876.67
5. Totals						21,761,601.55	740,876.03

6. Average rate of interest assumed in computing life insurance reserves (total of column 8 divided by total of column 7) ..... 3.40420 %

*See instructions for 809(d) and 809(e) adjustments. **Adjusted under 809(e) (Attach schedule)

PART V—ADJUSTED LIFE INSURANCE RESERVES (Sec. 809(a)(1))

1. Mean of the reserves (col. 7, line 5, Part IV)		21,761,601.55
2. (a) Multiplied by that percentage which equals	100%	
(b) Increased by 10 times the average rate of interest assumed (from line 6, Part IV)	34.042 134.04200	
(c) Total	32.57502	
(d) Reduced by 10 times the adjusted reserve rate from line 2, Part I, Schedule B)		101.46698 %
(e) Line (c) less line (d)		22,082,869.23
3. Adjusted life insurance reserves (line 1 multiplied by line 2(e))		0

PART VI—INTEREST PAID (Sec. 805(a))

1. Interest on indebtedness	43,094.36
2. Amounts in the nature of interest	1,258.07
3. Discount on unpaid premiums	44,352.43
4. Total interest paid (lines 1-3)	

SCHEDULE G—BALANCE INVESTMENT INCOME (See Instructions)

1. Policyholders' share (Sec. 809) (line 4, Part I, Sch. B, divided by line 14, Sch. A) but not to exceed 100%	85.30341 %	
2. Company's share	14.69659 %	
3. Total	100 %	

	1. Total	2. Exclusion Policyholders' share (line 1 times col. 1)	3. Company's share (line 1 times col. 1)
4. Interest wholly tax-exempt (line 1(a), column 4, Schedule A)	37,637.79	32,106.32	5,531.47
5. Interest partially tax-exempt (line 1(b) and (c), column 4, Schedule A)	0	0	0
6. (a) Dividends from line 2(a), Schedule A	0	0	0
(b) Dividends from line 2(b), Schedule A	0	0	0
(c) Dividends from line 2(c), Schedule A	0	0	0
(d) Dividends from line 2(d), Schedule A	0	0	0
7. Other items of investment yield (line 14, Schedule A, line 4-6 above)	857,639.82	731,596.01	126,043.81
8. Total (Lines 4-7)	895,277.61	763,702.33	131,575.28
REDUCTIONS			5,531.47
9. Interest wholly tax-exempt (line 4, column 3)			0
10. Interest partially tax-exempt (20/85 of line 5, column 3)			
11. Dividends received deductions			
(a) 85% of dividends from line 6(a), column 3		0	
(b) 82.118% of dividends from line 6(b), column 3		0	
(c) 85% of dividends from certain foreign corporations from line 6(c), column 3		0	
(d) Total, but not to exceed 85% of taxable investment income (line 14, Schedule C) computed without regard to the deduction			0
12. Small business deduction (10% of line 14, Schedule A, not to exceed $25,000)			25,000.00
13. Total (lines 9, 10, 11(d), and 12)			30,531.47
14. Taxable investment income (line 8 less line 13, but not less than zero)			101,043.81

196

EXHIBIT 1-TE

1. SCHEDULE E—GAIN AND LOSS FROM OPERATIONS (See instructions)			
1. Policyholders' share (See 809 (Line 3, Sch. E-1 divided by line 14, Sch. A), but not to exceed 100%			87.29566 %
2. Company's share			12.70434 %
3. Total			100 %
	1. Total	2. Policyholders' share (Line 1 times col. 1)	3. Company's share (Line 1 times col. 1)
4. Interest wholly tax-exempt (line 1(a), column 4, Schedule A)	37,637.79	32,856.23	4,781.56
5. Interest partially tax-exempt (lines 1(b) and (c), column 4, Schedule A)	0	0	0
6. (a) Dividends from line 2(a), Schedule A	0	0	0
(b) Dividends from line 2(b), Schedule A	0	0	0
(c) Dividends from line 2(c), Schedule A	0	0	0
(d) Dividends from line 2(d), Schedule A	857,619.62	748,664.06	108,955.76
7. Other items of investment yield (line 14, Schedule A less 4-6 above)	895,277.61	781,520.29	113,737.32
8. Total (lines 4-7)			6,168,700.63
9. Gross premiums 6,319,787.11 Less: Return premiums, etc. 151,086.48			0
10. (a) Decrease in reserves (after adjustment under 810(a)) (Attach schedule)			0
(b) Decrease in 810(b)(2) reserves (See line 3, Part IV, Schedule E-2)			582.22
11. Other amounts (Attach schedule)			6,293,029.37
12. Total (lines 8-11)			3,612,468.01
DEDUCTIONS			669,621.65
13. Death benefits, etc.			0
14. Increase in reserves (after reduction for investment yield under 810(b)) (Attach schedule)			4,781.56
15. Assumption by another person of liabilities under insurance, etc., contracts			0
16. Interest wholly tax-exempt (line 4, column 3)			10,183.03
17. Interest partially tax-exempt (30/52 of line 5, column 3)			25,000.00
18. Investment expenses, etc., not deducted on Schedule A (Attach schedule)			170,673.90
19. Small business deduction (10 percent of line 14, Schedule A, not to exceed $25,000)			5,492,728.15
20. Other deductions not deducted on Schedule A (Attach schedule)			
21. Total (lines 13-20)			
22. Dividends received deduction (See instructions)			
(a) 85% of dividends received from line 6(a), column 3	0		
(b) 62.115% of dividends from line 6(b), column 3	0		
(c) 85% of dividends from certain foreign corporations from line 6(c), column 3	0		
(d) Total, but not to exceed 85% of the excess, if any, of line 12 over line 21			0
23. Operations loss deduction (Attach schedule)			0
24. Tentative deduction (lines 21-23)			5,492,728.15
25. Plus: (a) Group life, accident, and health insurance (line 7, Part I, Schedule E-2)			47,749.74
(b) Certain nonparticipating contracts (line 9, Part I, Schedule E-2)			127,116.96
(c) Dividends to policyholders (Line 11, Part I, Schedule E-2)			451,368.22
26. Total deductions (line 24 plus line 25)			6,120,963.07
27. Gain (loss) from operations (line 12 less line 26)			162,057.30

EXHIBIT 1-TE

Page 4

SCHEDULE S-1.—REQUIRED INTEREST (Sec. 809(a)(2))

	1. Rate	2. Beginning of Taxable Year	3. End of Taxable Year	4. Mean (Columns 2 plus 3)	5. Column 1 times column 4
1. 810(d)(1) Reserves (From line 5, column 8, Part IV, Schedule B)					740,876.03
2. 810(d)(2) Reserves	Various	730,213.00	705,412.00	717,844.00	21,691.29
3. 810(d)(4) Reserves	Various	490,726.00	534,839.00	512,782.00	17,649.10
4. 810(d)(5) Reserves	Various	50,218.21	62,167.01	56,192.61	1,123.84
5. Required interest (Total, lines 1–4)					781,340.32

SCHEDULE S-2.—PART I—LIMITATION ON LINE 23, SCHEDULE E DEDUCTION (Sec. 809(i))

1. Statutory amount			250 000
2. (a) From line 12, Schedule E	6,283,020.37		
(b) Less: Tentative deduction, line 24, Schedule E	5,492,728.15		
3. Gain from operations (after regard to line 23, Schedule E	790,292.22		
4. Less: Taxable investment income (line 14, Schedule C)	101,043.61		
5. Excess of line 3 over line 4 (but not less than zero)		689,248.61	
6. Maximum possible deduction (or line 23, Schedule E (line 1 plus line 5)		939,248.61	
7. Deduction for group life, accident, and health insurance (Part II) (Not in excess of line 6)		47,749.74	
8. Maximum deduction for certain nonparticipating contracts (line 6 less line 7)		891,498.87	
9. Deduction for certain nonparticipating contracts (Part III) (Not in excess of line 8)		127,116.90	
10. Maximum deduction for dividends to policyholders (line 8 less line 9)		764,381.97	
11. Deduction for dividends to policyholders (Part IV) (Not in excess of line 10)		453,368.22	

PART II—GROUP LIFE, ACCIDENT, AND HEALTH INSURANCE (Sec. 809(d)(8))

1. Net premiums		2,387,487.19
2. Multiplied by		2%
3. Tentative deduction		47,749.74

PART III—CERTAIN NONPARTICIPATING CONTRACTS (Sec. 809(d)(5))

1. (a) Reserves at the end of the taxable year	20,550,115.02		
(b) Reserves at the beginning of the taxable year	19,278,945.38		
(c) Increase (If the difference is negative, enter "0")	1,271,169.64		127,116.96
(d) Multiplied by	10%		
2. (a) Net premiums	3,065,670.34		
(b) Multiplied by	3%		91,970.29
3. Tentative deduction—the greater of line 1 or line 2			127,116.96

PART IV—DIVIDENDS TO POLICYHOLDERS (Sec. 809(d)(3))

1. Dividends paid to policyholders			444,456.63
2. (a) Increased by the excess of (1) over (2):			
(1) Reserves as of the end of the taxable year	204,949.47		
(2) Reserves as of the end of the preceding taxable year	196,037.88		8,911.59
(b) Decreased by the excess of (1) over (2):			
(1) Reserves as of the end of the preceding taxable year			
(2) Reserves as of the end of the taxable year			
3. If positive, enter on line 11, Schedule S-2; if negative, enter on line 10(b), Schedule S			453,368.22

138

APPENDIX A

UNITED STATES COURT OF APPEALS
TENTH CIRCUIT

March Term, 1964

No. 7424

ATLAS LIFE INSURANCE COMPANY, APPELLANT

vs.

UNITED STATES OF AMERICA, APPELLEE

APPEAL FROM THE UNITED STATES DISTRICT COURT FOR THE NORTHERN DISTRICT OF OKLAHOMA

May 25, 1964

Before MURRAH, *Chief Judge,* and BREITENSTEIN and HILL, *Circuit Judges*

MURRAH, *Chief Judge.*

The taxpayer, a life insurance company, appeals from a judgment of the District Court (Atlas Life Insurance Co. v. United States of America, 216 F. Supp. 457), denying refund of income taxes paid by it, pursuant to the Life Insurance Company Tax Act of 1959. 26 USC 801 et seq. The Act imposes a tax at ordinary corporate rates upon "life insurance com-

pany taxable income" (§ 802(a)), based upon a three-phase calculation under Section 802(b), which, for our purposes, involves only the first two steps, namely: the determination of "taxable investment income" and "gain from operations" as defined in Sections 804 and 809, respectively.

The taxpayer computed and paid its income taxes for the year 1958 in accordance with the statutory definitions. It thereafter filed claim for refund, contending that the application of the statutory definitions "taxable investment income" and "gain from operations" resulted in the imposition of a tax on tax-exempt interest received from municipal bonds, and that it is therefore entitled to an adjustment under the provisions of Sections 804(a)(6) and 809(b)(4).

The Act of 1959 was promulgated in response to the recognized need for a more permanent and equitable method for determining taxable income of life insurance companies, and was the result of a comprehensive reappraisal of former legislation in the area. The formula for the determination of the tax was conceived in recognition of two salient principles of tax immunity: (1) the policy which has inhered in income tax law since its inception in 1913, to the effect that interest on state securities is excluded from gross income in the computation of the taxpayer's federal tax liability;[1] and (2) in recognition of the traditional concept that a life insurance company should not be taxed on that part of its income which is required to be set aside as a reserve to meet the company's contingent obligations to its policyholders. See 2 USC, Congressional and Administrative News, 86th

[1] This concept is presently embodied as a general rule in Section 103, 26 USC Sec. 103, but is not applicable to the tax treatment of life insurance company tax-exempt interest.

Congress, First Session, 1575; Wurzel, "Tax-Exempt Interest of Life Insurance Companies", 70 Yale L.J. 15 (1960).

The concept of "reserve deduction" is perpetuated in the Act by the division of each and every item of net investment income into two catergories; (1) the policyholders' share which is excluded from tax liability; and (2) the Company's share which is subject to taxation. To effectuate the division of the Company's share from the policyholders' share of the net investment income, the Act first provides for the determination of net investment income, i.e., "investment yield", or gross investment income, including tax-exempt interest, less certain expenses. See §§ 804(c), 804(a)(1) and 809(a)(1). The policyholders' percentage share of investment yield is determined by dividing investment yield into "policy and other contract liability requirements." § 804(a)(1). These requirements are calculated in accordance with the complicated formula provided in Section 805 by adding: the product of the company's "adjusted reserves rate" [2] and its "adjusted life insurance reserves"; [3] the

[2] The "adjusted reserves rate" is the lower of the average earnings rate or the current earnings rate. § 805(b)(1) The "current earnings rate" is the investment yield divided by the mean of the company's assets. § 805(b)(2) The "average earnings rate" is the average of the current earnings rates for the taxable year and for each of the four preceding taxable years. § 805(b)(3).

[3] The "adjusted life insurance reserves" is the mean of life insurance reserves, other than pension plan reserves, adjusted upward by one percent for every tenth of a percent by which the "adjusted reserves rate" is less than the assumed interest rate used in calculating such reserves. If the "adjusted reserves rate" exceeds the assumed interest rate, the reserves are adjusted downward in a similar manner. § 805(c).

pension plan reserves multiplied by the current earnings rate;[4] and interest paid. The percentage derived from the use of this formula[5] represents the policyholders' percentage share, and the remaining portion of 100 percent is the company's percentage share. The life insurance company's percentage share of each and every item of investment yield is then reduced by its percentage share of tax-exempt interest,[6] and the result is taxable investment income.

The second phase for calculating the base tax, i.e., "gain from operations", follows a similar pattern in determining the policyholders' share of investment yield. Though the formula is different,[7] it is sufficient for our purposes to note that, as in phase one, the tax-exempt interest is included to determine the respective percentage shares, and the company's share of exempt interest is then deducted to arrive at gain from operations. See § 809. Thus, after the computation of tax-

---

[4] See Footnote 2 for explanation.

[5] It is important to note that investment yield which includes tax-exempt interest is not only the denominator of this formula, but it also significantly affects the determination of the numerator.

i.e. $\frac{\text{policy and other contract liability requirements}}{\text{investment yield}}$

And See Footnotes 2 and 3.

[6] Other deductions are specified in § 804(a)(2)(A).

[7] The policy holders' percentage share of gain from operations is determined by dividing "investment yield" into "required interest" as defined in Section 809(a)(2) instead of "policy and other contract liability requirements." The company's share of each and every item of "investment yield" is then added to the net premium receipts which is reduced by specified deductions, including the company's share of tax-exempt interest. See § 809(d). The result is "gain from operations."

able investment income and gain from operations, Section 802(b) specifies their proper relationship to determine "life insurance company taxable income", i.e., the sum of taxable investment income and 50 percent of the excess of gain from operations over taxable investment income.

The Act then finally provides as an "exception" that "if it is established in any case that the application" of the definitions of taxable investment income and gain from operations "results in the imposition of tax on" any tax-exempt interest, "adjustment shall be made to the extent necessary to prevent such imposition." §§ 804(a)(6) and 809(b)(4).

Making application of the statutory formula in its return for 1958, the taxpayer first computed its tax liability to be $62,615.05. And, it does not now dispute the correctness of the calculations of its tax liability under the formula. The contention is rather that the application of the formula results in its tax liability being increased by $11,252.19, solely because of the receipt of tax-exempt interest and its inclusion in the determination of the tax base. The claim for refund is based on computation of the company's tax liability without the inclusion of tax-exempt interest in investment yield as used in the formula for determining the tax base.

An interpretative analysis of the table below[8] reveals the extent to which the inclusion or exclusion of

[8] This table illustrates the differential in the company's tax liability under the statutory formula and the taxpayer's computations of its liability based upon the exclusion of the tax-exempt interst from investment yield whenever it becomes operative under the formula. Neither party disputes the correctness of the arithmetic computations which reflect the

tax-exempt interest in or from investment yield permeates the whole computation of tax liability. Thus, in phase one, a reduction of the adjusted reserves rate results because it is the lower of the two earnings rates, which are in essence determined by dividing assets into investment yield. See Footnote 2. The effect of the reduction in the adjusted reserves rate on policy and other contract liability requirements is par-

application of their respective theories of the company's statutory tax liability.

Phase 1: Computation of Taxable Investment Income

Item	Statutory formula	Exempt interest excluded
Investment Yield	$894, 277. 61	$857, 639. 82
Current Earnings Rate	3. 33390%	3. 19731%
Average Earnings Rate	3. 253782%	3. 12297%
Adjusted Reserve Rate	3. 253782%	3. 13397%
Adjusted Life Ins. Reserves Rate	$22, 090, 965. 28	$22, 375, 659. 00
Policy & Other Contract Liability Requirements	$763, 144. 28	$743, 137. 55
Policyholders' Percentage Share	85. 3364%	86. 6491%
Company's Percentage Share	14. 6636%	13. 3509%
Company's Share of Items of Investment Yield	$131, 183. 29	$114, 502. 27
Deduction of Tax-Exempt Interest	$5, 372. 42	none
Taxable Investment Income	$100, 760. 87	89, 502. 27

Phase 2: Computation of Gain from Operations

Item	Statutory formula	Exempt interest excluded
Investment Yield	$894, 277. 61	$857, 639. 82
Required Interest	781, 540. 32	781. 540. 32
Policyholders' Percentage Shares	87. 3934%	91. 1269%
Company's Percentage Share	12. 60652%	8. 8731%
Company's Share of Items of Investment Yield	$112, 737. 29	$76, 099.50
Deduction of Tax-Exempt Interest	$4, 618. 75	none
Gain from Operations	$161, 220. 08	$129, 201. 04

Tax Computation

Item	Statutory formula	Exempt interest excluded
Taxable Investment Income	$100, 760. 87	$89, 502. 27
50% of the Excess of Gain from Operations over Taxable Investment Income	30, 229. 61	$19, 849. 39
Life Insurance Co. Taxable Income	$130, 990. 48	$109, 351. 66
Total Income Tax*	$62, 615. 05	51, 362. 86

*The $11,252.19 differential constitutes the claimed refund.

tially offset by the increase in the adjusted life insurance reserves caused by the greater difference between the adjusted reserves rate and the assumed interest rate. See Footnote 3. Although policy and other contract liability requirements are lower, the policyholders' percentage share is greater because of the exclusion of the exempt interest from investment yield. Conversely, the Company's percentage share is greater because of the inclusion of exempt interest in investment yield. Thus, the percentage differential and the ultimate increase of taxable items of investment yield included in taxable investment income are attributable to the inclusion of tax-exempt interest.

Similarly, in the phase two computation, exclusion of tax-exempt interest from investment yield results in an increased policyholders' percentage share, because it is calculated by dividing investment yield into required interest which remains the same. Thus, the difference in the Company's percentage shares is attributable to the inclusion of the exempt interest, and this in turn accounts for the variation in gain from operations.

The trial court's conclusion that the receipt by the taxpayer of exempt interest was not in fact taxed, is apparently based upon the interpretation of the statutory formula, to the effect that the "company's tax-exempt interest is included in gross income and then deducted before reaching the tax base of the Taxpayer." Atlas Life Insurance Co. v. United States of America, supra, p. 460. The fallacy of this interpretation is that it fails to recognize what the Government seems to concede, that the increase in the Company's share of investment yield by the inclusion of exempt interest in the formula for determining the respective percentage shares is not offset by the deduction of the Company's percentage share of exempt

interest, and that the ultimate tax liability is in fact increased.

The judgment of the trial court is sought to be sustained on the theory that although the inclusion of tax-exempt interest in the formula results in an increase in the Company's share of all other income, it will be exactly what it would have been if the Company had received taxable income, and that the application of the statutory definitions does not therefore result in a tax on tax-exempt interest. The Government says this is "precisely what Congress intended." And, they justify it by emphasizing the design of the statute to divide the ownership of all investment income, and that this has the concomitant effect of dividing the tax-exempt interest between the policyholders and the Company. This method of prorating the exempt interest is said to be an exertion of the "full power" of Congress to classify income for tax purposes, and in this particular case, to prevent a double deduction through the interplay of the exclusion of the policyholders' share and the deduction of exempt interest.

The Government attacks the taxpayer's formula which eliminates the exempt interest from the computation as in effect allocating all taxable dollars to the policyholders and all tax-exempt dollars to the Company, thus creating a loophole which the statute was designed to prevent.

If, as the Government contends, the Congress, in enacting the taxing formula, intended to test anew the doctrine of inter-governmental tax immunity by exerting its full constitutional powers to classify income for tax purposes, our inquiry is simply whether, judged by present-day concepts, the Congress overstepped its constitutional bounds. But, the taxpayer takes the position that Congress legislated with an

eye to the doctrine of National Life Insurance Co. v. United States, 277 U.S. 503; and Missouri v. Gehner, 231 U.S. 313, according to which the sovereign may not subject a taxpayer to a greater burden on his income solely because of the receipt of tax-exempt interest. As we view our lawsuit in the context of the respective contentions of the parties, it involves the determination of the extent to which the Congress intended to exercise its power of taxation with respect to tax-exempt interest received by life insurance companies.

While resort to legislative history is usually justified only in cases of ambiguity in the statutory language, i.e., see Nicholas v. Denver & R.G.W. R. Co., 195 F. 2d 428, it is frequently relied upon for the ascertainment of a Congressional purpose as embodied in the final enactment. See Flora v. United States, 362 U.S. 145; United States v. Harriss, 347 U.S. 612; United States v. American Trucking Assn., 310 U.S. 534; Caminetti v. United States, 242 U.S. 470; Sutherland on Statutory Construction, Vol. 2, p. 481 et seq. In the words of Mr. Justice Frankfurter, dissenting in Reed v. Pennsylvania RR Co., 351 U.S. 502, 510, "The process of judicial construction must be mindful of the history of the legislation, of the purpose which infused it, of the difficulties which were encountered in effectuating this purpose, of the aims of those most active in relieving these difficuties." To support their positions, both the Government and the taxpayer rely heavily on the extensive legislative history of the Act as influenced by the contemporary case law. We will therefore examine it to determine the purpose and scope of the taxing act.

The parties start with the Revenue Act of 1921 and particularly Section 245(a), 42 Stat. 227, 261, which provided that in the case of life insurance companies,

743-750—64——2

net income means gross income less certain deductions, inter alia, (1) the amount of interest received from tax-exempt securities; and (2) a reserve deduction reduced by the amount of exempt interest. In National Life Insurance Co. v. United States, supra, the Supreme Court held that the diminution of the reserve deduction by the amount of exempt interest had the effect of destroying the guaranteed exemption. The underlying principle, as announced by the Court, was to the effect that a taxpayer may not be subject to a greater tax burden on his taxable income solely by reason of the receipt of tax-exempt interest.

There were strong and persuasive dissents in which it was suggested that since the reserve deduction was a matter of grace or bounty, the Congress was perfectly free to reduce it by the amount of exempt interest, or any other amount for that matter. The dissenters did not think that the Constitution or the laws guaranteed that "a holder of tax-exempt bonds, shall be better off than if he held only taxable securities"; nor did it require that "those who do not hold tax-exempt securities shall, in respect to every tax, be subjected to a heavier burden than the owners of tax-exempt bonds." National Life, supra, p. 528.

Apparently, on the authority of National Life, the Supreme Court in Missouri v. Gehner, supra, reversed the Missouri Supreme Court which, in considering a state property tax, had upheld the apportionment of reserves and claims between taxable and non-taxable assets, including United States bonds. The Court restated the National Life doctrine to the effect that a "State may not subject one to a greater burden on his taxable property merely because he owns a tax-exempt government securities." Missouri v. Gehner, supra, p. 321. The same dissenters, speaking through Mr. Justice Stone in Gehner, were of the opinion that

nothing in National Life required a reversal of this case. They insisted that tax-free securities might well be realistically held accountable for their share of reserves for claims in computing the tax. Otherwise, said they, an affirmative benefit is conferred upon the ownership of tax-exempt securities "at the expense of the taxing powers of the state, by relieving the owner from the full burden of taxation on net worth to which his taxable assets have in some measure contributed." Gehner, supra, p. 328. It would thus appear that the dissenters would have given little or no respect to the doctrine of intergovernmental tax immunity. In any event, it seems reasonable to say that the same vigorous dissenters in both National Life and Gehner would find no fault in the asserted power to apportion tax-exempt income between the reserve deduction and taxable income for the purpose of arriving at the taxpayer's tax liability.

Another contemporary decision of the Supreme Court, Denman v. Slayton, 282 U.S. 514, also involved the 1921 taxing Act, particularly Section 214(a)(2), 42 Stat. 227, 239, which denied a deduction for interest paid on indebtedness incurred to purchase or carry tax-exempt securities. In his return for the taxable year 1922, the taxpayer excluded interest received on tax-exempt muncipal bonds and deducted the interest on money borrowed to purchase and carry the bonds. The Commissioner disallowed the deduction and the lower court sustained the taxpayer on the authority of National Life. But, a unanimous Supreme Court, in an opinion by the writer of National Life, held that National Life was "radically different", and that its doctrine did not control. The Court went on to say that "while guaranteed exemptions must be strictly observed, this obligation is not inconsistent with reasonable classification designed to subject all to the

payment of his just share of a burden fairly imposed." Denman v. Slayton, supra, p. 519.

Such was the state of the decisional law as Congress continued to wrestle with the problem of finding a just and appropriate method of determining life insurance companies' taxable income. The 1921 Act apparently was not amended to reflect the National Life restriction on reserve deduction until the 1932 Act, which simply deleted the objectional provision for diminution of the reserve deduction by the amount of exempt interest. 47 Stat. 169, 224; § 203 of Revenue Act of 1932. This text of the law was carried forward and observed until 1942 when a new system was introduced. 56 Stat. 798, 868–870, §§ 202 and 203 of the Revenue Act of 1942. This Act prescribed a reserve deduction expressed as a percentage of investment income, including tax-exempt interest based on industry-wide experience. Each company applied this percentage to its net investment income, but was allowed to deduct all its tax-exempt interest before prorating its net investment income.

As in our formula, the 1942 Act included exempt interest in its formula for determining the industry-wide reserve deduction percentage. And, this percentage, which was applied to determine the individual company reserve deduction, was decreased by the inclusion of tax-exempt interest. This had the theoretical effect of increasing the percentage of net investment income which is taxable. But no taxpayer was induced to test the added tax burden as against the doctrine of National Life, apparently for two reasons: (1) the industry-wide reserve deduction percentage was so great that the individual company's net taxable investment income was minuscule; (2) each company could minimize its tax burden by purchasing tax-exempt securities because the income

therefrom was not included in the computation of their individual tax liability. This situation obtained without significant change until 1958. See Wurzel, Yale L.J., supra, p. 20–21.

After considerable study, the House passed a Bill which provided for the determination of insurance company tax liability in three steps on an individual company basis. The step one base was the difference between the taxable net investment income, as reduced by the total amount of exempt interest, and the reserve deduction, as reduced by its allocable share of exempt interest. See: §§ 804 and 805, H.R. 4245, Hearings Before Senate Finance Committee on H.R. 4245, 86th Cong., First Sess. (1959), pp. 4–7. The provisions of the House Bill in this regard are noticeably similar to the so-called "Add-Back" provisions of Section 245(a)(2) of the 1921 Act, the distinction being that the reserve deduction was not diminished by the total amount of exempt interest, but only its prorata share. It is also noteworthy that the mathematical result of the House formula is conceded by all parties to be identical with the result obtained in the final Act.[9] The insurance companies apparently did not detect the shades of the 1921 Act in the House Bill until it came before the Senate. It was then that they apparently became aware that their tax liability might be increased solely by reason of the receipt of tax-exempt interest.

When the Treasury came before the Senate Finance Committee to urge the adoption of the House Bill, the Treasury witness, explaining the provisions of the proposed legislation, observed that while the tax-exempt interest was excluded in both phases of the

[9] The formula for step 2 proceeded along the same lines and, with a result also identical to the final Act. See: § 809, H.R. 4245, Hearings, supra, pp. 8–10.

Bill, an adjustment was made "to the deductions to avoid a double benefit * * *." He also agreed that it was "probably a fair statement" to say that the adjustment was in reality charging a part of the operating expense against tax-free interest. When asked why the Treasury proposed to tax-exempt interest, "even partially", the witness candidly answered: "Because we think it is right." In answer to further queries whether such a provision would render the bill unconstitutional, the witness also candidly admitted that he thought the question "might very well be litigated", and that "we should determine with the best advice we can, as to whether or not we today think such a provision is unconstitutional, and if we believe it is not, and if we believe the provision is right, we ought to include it in the bill." Hearings, supra, pp. 43–44.

The extensive pro and con hearings before the Senate Finance Committee on the House Bill reflect strong representations on the part of insurance companies and those interested in the marketability of tax-exempt securities, to the effect that the proration of the tax-exempt interest between the reserve deduction and net investment income resulted in a tax burden on exempt interest, contrary to National Life, and was therefore constitutionally impermissible. In short, they rested their case principally on the constitutional limitations of National Life and Gehner.[10] There was the further strong representa-

[10] One witness, president of a large life insurance company, in his statement purported to represent 120 companies: "We believe that, in its treatment of tax-exempt interest, H.R. 4245 contravenes the decision of the Supreme Court in the case of National Life v. United States. We think that if it was unconstitutional to add back 100 percent of tax-free interest to the tax base under the 1921 law, then adding back only 70

tions that the resultant burden on the exempt security would adversely affect their marketability in competition with taxable securities—a result which Congress would wish to avoid."[11]

As we summarize the Government's representations to the Senate Committee, they were based primarily on the thesis that the trend of the recent Supreme Court decisions was away from the National Life doctrine of intergovernmental tax immunity, and toward the minority view; that in any event, the House Bill formula was unlike the 1921 formula, and in substance the same as the 1942 formula, which

---

percent of such interest is unconstitutional, too." Hearings, supra, p. 305. He also filed a lawyer's brief on the constitutional question. See Hearings, p. 308.

Another witness, vice-president of a life insurance company, stated that "As H.R. 4245 now stands, it is not possible for a life insurance company to invest either its capital or surplus funds in municipal bonds and receive the interest on them free from tax; at least, not unless it first invests all of its policyholders' reserve funds in municipal bonds. And this would be absurd." Hearings, supra, p. 406. He too supplemented his testimony with a memorandum on the constitutionality of taxation of tax-exempt interest, in which it was "observed that the pro rata disallowance rule under the Ohio (sic) statute which was held unconstitutional in the Missouri v. Gehner case is very similar to the pro rata rule contained in Section 809(d) of the present bill." Hearings, supra, 408.

See also: Hearings, supra, pp. 614, 632.

[11] The executive director of an association representing 13,000 municipal governments submitted a statement in which H.R. 4245 was characterized as "* * * the opening wedge to apply the same principal to all other taxpayers." It also noted the "* * * * higher interest rates which State and local governments would have to pay if such a Federal tax were imposed on all their bonds in the future." Hearings, supra, p. 699. An association composed of 6,000 county officials endorsed this statement. See Hearings, supra, p. 699–700.

See also Id., p. 106, 187–188, 252, 305, 405, 632, 687.

had the effect of preventing a double deduction for tax-exempt interest, and which had never been challenged in the courts. See: Hearings, supra, p. 48–51.

It is not manifestly clear what considerations prompted the Senate Committee to revise the House Bill, but the fact is that it did reapproach the problem somewhat differently with respect to the treatment of tax-exempt interest. One of the innovations deemed important in the Senate version was division of the ownership of income and expense items between the policyholders and the insurance company, with only the company's share being taken into account for tax purposes. See: 2 USC Cong. & Adm. News, supra, p. 1580. The Senate Committee seemed to think that by dividing ownership of investment income by the use of a formula which included all tax-exempt interest, and the deduction of the company's pro rata share from its tax base, was preferable to the House formula, which excluded all tax-exempt interest from investment income, but reduced the deduction for policy and other contract liability requirements by its pro rata share of exempt interest.[12] Apparently, being unsure of the tax consequences of what they had done, but "to give further assurance that no tax is to be imposed on tax-exempt interest", the Senate then added the exception Sections

[12] After comparing the two treatments, the Committee Report added: "Your committee believes that the division of income and expense items between the policyholders and the insurance company, with only the latter being taken into account for tax purposes, is a much better concept to follow. It also makes it clear that items which are properly exempt * * * such as tax-exempt state and municipal bond interest * * * are properly divided between the policyholders and the life insurance company and that as far as the latter is concerned, namely, the only portion included in the tax base, full allowance is made for these items.". 2 USC Cong. & Adm. News, p. 1580.

804(a)(6) and 809(b)(4). 2 USC Cong. & Adm. News, supra, p. 1592.

When the Senate version came to the Floor for consideration the Chairman of the Finance Committee, reporting on the Bill, stated that it was "the intention of the Committee not to impose any tax on tax-exempt interest"; and that the "Treasury has assured the Committee that this formula does not impose any tax on tax-exempt interest. The bill adds a proviso to the effect that if the formula I have described does not result in the imposition of tax on this item, the formula is to be adjusted so that it does not do so." [13]

---

[13] Senator Curtis, who was asked to make the detailed explanation of the statute, made the following statement on the floor of the Senate before the amended version was adopted: "I wish to mention a matter which has deeply concerned your committee. That was the problem of making sure that we did not, by inadvertence, tax any of a life insurance company's tax-exempt interest income. The bill meets this problem most accurately and fairly." He concluded his discussion of the treatment of tax-exempt interest with the following example: "Under the bill, $70 of the $100 tax-exempt interest income would be allocated to policyholders' reserve, and the other $30 would be allocated to the company. Since no part of the policyholders' reserves would become a part of the tax base, no part of the $70 tax-exempt interest allocated to those reserves would be taxed. Moreover, no part of the $30 allocated to the company would be taxed, because a deduction of the full $30 would be made in determining what part of the company's share of its investment income was to be subject to tax.

"Thus, no tax-exempt income or credits of life insurance companies will be included in the tax base of such companies, under this bill. This should allay any fear that any constitutional provision is transgressed." 105 Cong. Record, Part 6, p. 8429. Representative Mills, after the conference committee reached agreement on the final Act, reported to the House: "It is my belief that the appropriate deduction was allowed by the House bill and that these provisions of the final bill, which closely follow the Senate amendments, make no change of sub-

105 Cong. Record, Part 6, p. 8401. A letter from the Treasury, read to the Senate, stated that "It has been the objective of the provisions in question to exclude fully from tax in the hands of life insurance companies the interest on State and municipal bonds. At the same time, however, it has been considered essential not to allow anything in the nature of a double deduction or tax loophole arising from the special characteristics of the unique formula to be applied to these companies." The letter again reviewed the statutory formula for determining an insurance company's taxable income and, referring to the exception sections, expressed the view that "this additional language is not necessary, since we cannot envision a situation in which the operation of the proposed tax formula would result in the substantive imposition of tax on municipal bond interest or on any other form of tax-exempt income." 105 Cong. Record, Part 6, p. 8402. What the Treasury meant by a "substantive imposition" of tax on exempt interest is a matter of doubt and speculation. But, considered in the context of the views expressed before the Committee, and the position taken here, it seems fair to assume that the Treasury recognized that though the inclusion of tax-exempt interest in the formula resulted in an increase of the taxpayer's burden, it was nevertheless within the taxing power of the Congress and would not therefore result in an impermissible imposition, and we consequently have no need to employ the exception provisions of the statute.

Whatever may be said of the extent of the Congressional power to indirectly burden exempt interest in

---

stance." 105 Cong. Record, Part 8, p. 10412. He further stated that the final Act "* * * clarified the language of the House bill to make it definite that we do not intend to tax the interest on tax-exempt securities." Id., 10414.

the exercise of its power to classify all income for purposes of taxation; and whatever may be said of the government's conception of the Congressional intent and purpose to observe those precepts in the enactment of this legislation, it seems manifestly plain to us that Congress did not intend to invade the integrity of the intergovernmental tax immunity doctrine as exemplied in the decisional law when the legislation was under consideration. The prenatal history of this Act convinces us that Congress legislated with an ear to the problem of the marketability of state and municipal securities, and with an eye to the constitutional limitations of National Life on the Congressional power to increase the tax burden of a life insurance company, solely by reason of the receipt of interest from state or municipal securities.

The question then is whether this is a National Life-Gehner case. The trial court did not think so, and, basing its decision on Slayton, concluded that there was in fact no imposition of a prohibited tax. We conclude that our case is within the ambit of the National Life case, which is "radically different" from Slayton. In National Life, the Court invalidated Section 245(a) of the 1921 Act because it in effect increased the taxpayer's tax liability, solely by reason of the receipt of tax-exempt interest. In Slayton, the same Court upheld Section 214(a) of the same Act as a valid measure to prevent the avoidance of tax on taxable income by the simple expedient of borrowing to purchase tax-exempt securities. As the Court observed in Slayton, the taxpayer "was not in effect required to pay more upon his taxable receipts than was demanded of others who enjoyed like incomes solely because he was the recipient of interest from tax-free securities—a result which we found would have followed enforcement of the literal provisions of Section 245(a)." Denman v. Slayton, supra, 519.

And see Helvering v. Independent Life Insurance Co., 292 U.S. 371, 381.

While the extent of the burden on the exempt interest and the form and method of imposing it in our case may differ from National Life, the taxable effect differs only in degree. In both instances the liability of the taxpayer is increased, solely by reason of the receipt of tax-exempt interest, and no form or method for determining it can disguise its incidence. We conclude that the application of the definitions in the Act does result in the imposition of a tax on exempt interest, and the taxpayer is therefore entitled to an adjustment to the extent necessary to prevent such imposition.

It is incumbent upon the taxpayer to prove the amount of the adjustment. It says that it is $11,252.19, and arrives at this amount by simply eliminating exempt interest wherever it is operative in the computation under the statutory formula. While the Government does not quarrel with the taxpayer's arithmetic, it strenuously denies support or sanction of the formula by which it is computed. In that respect it says that the treatment of the tax-exempt interest is the same as if the money used to purchase tax-exempt securities had remained idle.

Be that as it may, the Congress has expressly provided for an adjustment to the extent necessary to prevent the imposition of tax on the exempt interest. And, since we hold that the application of the statutory definitions does in fact result in a prohibited imposition; and since the taxpayer's computations are based upon the elimination of that interest, we must conclude that the adjustment does no more than prevent the prohibited imposition.

Insofar as the judgment of the trial court denies refund of $11,252.19, it is reversed with directions to enter judgment accordingly.

BREITENSTEIN, *Circuit Judge* (concurring in result).

I find it unnecessary to go into the details of the mathematical formulas provided by §§ 804 and 809 of the Life Insurance Company Income Tax Act of 1959, 26 U.S.C. §§ 801–820, or to explore the legislative history of that Act.

Income of the companies subject to the Act is divided into a policyholders' share and a company's share. The company is taxed on its share. The uncontroverted showing of Atlas is that, on the facts pertaining to its 1958 income, the inclusion of interest on tax-exempt securities in the statutory formulas increases the company's share and results in a tax of $11,252.19 more than would have been payable if tax-exempt income had been excluded therefrom. The imposition of tax in this amount results solely from the inclusion in the formulas of income from tax-exempt securities.

Both § 804(a)(6), relating to taxable investment income, and § 809(b)(4), relating to gain from operations, provide that if the application of the definitions found in those sections results in the imposition of a tax on interest which under § 103 is excluded from gross income (interest on state, municipal, and certain other securities), "adjustment shall be made to the extent necessary to prevent such imposition."

The operation of the formulas is such that the tax actually is imposed on taxable income, but this result does not excuse the United States for failing to make the adjustment. National Life Insurance Company v. United States, 277 U.S. 508, and Missouri ex rel. Missouri Insurance Company v. Gehner, 281 U.S. 313, hold that a tax is imposed on tax-exempt property by an increase in tax on taxable property arising solely from the ownership of tax-exempt property.

I grant the power of Congress to classify income, within constitutional limits, for income tax purposes;

and I recognize that the reserve deduction which comes from the division of income into the noted shares is a matter of congressional grace or bounty. The issue is the exercise of a power rather than the existence of a power. The statute under consideration discloses a clear intent not to tax income from state and municipal securities. No uncertainty in this regard exists to require recourse to legislative history for the ascertainment of congressional intent.

We are bound by the National Life and Missouri v. Gehner decisions. With full knowledge of those decisions, Congress provided that if the application of the statutory method causes a tax on tax-exempt income an adjustment shall be made to prevent such a result. By refusing to make the necessary adjustment the government, in effect, has written §§ 804(a)(6) and 809(b)(4) out of the statute. Atlas is entitled to recover the overpayment.

JUDGMENT

First Day, May Term, Monday, May 25th, 1964

Before Honorable ALFRED P. MURRAH, *Chief Judge*, and Honorable JEAN S. BREITENSTEIN and Honorable DELMAS C. HILL, *Circuit Judges*

This cause came on to be heard on the transcript of the record from the United States District Court for the Northern District of Oklahoma and was argued by counsel.

On consideration whereof, it is ordered and adjudged by this court that insofar as the judgment of the trial court denies refund of $11,252.19, it is reversed with directions to enter judgment accordingly.

117

Supreme Court of the United States

No. ---------- , October Term, 19 64

UNITED STATES OF AMERICA,

Petitioner

VS.

ATLAS LIFE INSURANCE COMPANY

ORDER EXTENDING TIME TO FILE PETITION FOR WRIT OF CERTIORARI

UPON CONSIDERATION of the application of counsel for petitioner(s),

IT IS ORDERED that the time for filing petition for writ of certiorari in the above-entitled cause be, and the same is hereby, extended to and including September 11, 19 64.

Associate Justice of the Supreme Court of the United States.

Supreme Court of the United States

No: 489 ----- , October Term, 19 64

United States,

Petitioner,

v.

Atlas Life Insurance Company

ORDER ALLOWING CERTIORARI. Filed December 7 ------ , 19 64.

The petition herein for a writ of certiorari to the United States Court of Appeals for the Tenth ---------- Circuit is granted, and the case is placed on the summary calendar.

And it is further ordered that the duly certified copy of the transcript of the proceedings below which accompanied the petition shall be treated as though filed in response to such writ.

INDEX

	Page
Opinions below	1
Jurisdiction	1
Question presented	2
Statutes involved	2
Statement	2
1. Life insurance reserves	4
2. The statute	5
3. Facts and proceedings below	9
Reasons for granting the writ	11
Conclusion	22
Appendix A	1a
Appendix B	23a

CITATIONS

Cases:

Denman v. *Slayton*, 282 U.S. 514 19

Missouri Insurance Co. v. *Gehner*, 281 U.S. 313 ..... 10, 11, 20, 21

National Life Insurance Co. v. *United States*, 277 U.S. 508 ..... 10, 11, 15, 20, 21

New York v. *United States*, 326 U.S. 572 20

743-760—64——1

Statute:

	Page
Internal Revenue Code of 1954, as amended by the Life Insurance Company Income Tax Act of 1959	2
§ 103	23a
§ 243	16
§ 244	16
§ 245	16
§ 662(a)(1) and (b)	18
§§ 801–820	2, 23a
§ 802(a)	24a
§ 802(b)	3, 4, 24a
§ 804(a)	3, 24a
§ 804(a)(6)	3, 16, 26a
§ 804(b)	26a
§ 804(c)	26a
§ 805	7
§ 805(a)	26a
§ 805(b)	27a
§ 805(c)(1)(B)	7, 28a
§ 809(a)(2)	5, 28a
§ 809(b)	29a
§ 809(b)(4)	3, 9, 16, 29a
Miscellaneous:	
105 Cong. Rec. 8401–8402	12
Hearing Before The Senate Committee On Finance on H.R. 5739, 88th Cong., 2d Sess.	16
Wurzel, *Tax-Exempt Interest of Life Insurance Companies*, 70 Yale L. J. 15 (1960)	17

In the Supreme Court of the United States

OCTOBER TERM, 1964

No. ——

UNITED STATES OF AMERICA, PETITIONER

v.

ATLAS LIFE INSURANCE COMPANY

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT

The Solicitor General, on behalf of the United States, petitions for a writ of certiorari to review the judgment of the United States Court of Appeals for the Tenth Circuit in the above-entitled case.

OPINIONS BELOW

The opinion of the district court (R. 15–22)[1] is reported at 216 F. Supp. 457. The opinion of the court of appeals (App. 1a–22a)[1] is reported at 333 F. 2d 389.

JURISDICTION

The judgment of the court of appeals was entered on May 25, 1964 (App. 22a). By order of Mr. Justice White, dated August 22, 1964, the time for filing a petition for a writ of certiorari was extended to and

[1] "R." refers to the Transcript of Record filed in the court of appeals; "App." to the appendix to this petition.

including September 11, 1964. The jurisdiction of this Court is invoked under 28 U.S.C. 1254.

QUESTION PRESENTED

Whether the constitutional doctrine prohibiting a tax on interest from State and municipal bonds requires Congress, in allocating a life insurance company's income between an untaxed "policyholder's share" and a taxed "company's share", to allocate all of the municipal bond interest to the company's share, thereby entitling the company to deduct the full amount of such interest from its share of the income. In the terms of the statute, the question is whether the definitions of "taxable investment income" and "gain from operations" in the Life Insurance Company Income Tax Act of 1959, by allocating the municipal bond interest pro rata between the two shares, result in an "imposition of tax on" municipal bond interest, thereby precluding the application of those definitions under the "exception" clauses of the statute (§§ 804(a)(6), 809(b)(4), Internal Revenue Code of 1954).

STATUTES INVOLVED

The relevant portions of the Internal Revenue Code of 1954, as amended by the Life Insurance Company Income Tax Act of 1959, are set forth in Appendix B, *infra*, pp. 23a–30a.

STATEMENT

Under the Life Insurance Company Income Tax Act of 1959 (§§ 801–820 of the Internal Revenue Code of 1954, as amended), the taxable income of a life insurance company includes the full amount of its "gain

from operations" up to the amount of its "taxable investment income," plus one-half of any additional "gain from operations" (§ 802(b)). "Taxable investment income" and "gain from operations" are defined in detail in §§ 804(a) and 809(b), respectively, but each of those provisions contains an "exception" providing that, if the application of the definition "results in the imposition of tax on" State and municipal bond interest, "adjustment shall be made to the extent necessary to prevent such imposition" (§§ 804(a)(6), 809(b)(4)).

In its income tax return for 1958, respondent computed its income in accordance with the statutory definitions of "taxable investment income" and "gain from operations." In due course, however, it brought this suit for refund contending that the application of the statutory definitions resulted in the imposition of tax on its municipal bond interest. The court of appeals, reversing the district court, held that the statute does impose a tax on municipal bond interest and, to eliminate that effect, adjusted respondent's tax under the "exception" clauses.

A fuller statement of the issue and of the reasoning of the court below requires an explanation of the nature of life insurance reserves and of the statutory plan for the taxation of life insurance companies. Since the statutory definitions of "taxable investment income" and of "gain from operations" present the same issue but require somewhat different computations, we will for simplicity hereafter confine the discussion, except as otherwise expressly noted, to the definition of "gain from operations," the definition

that requires the simpler and more easily understood computations.[2]

1. *Life insurance reserves.*—The premiums charged for life insurance are calculated on the assumption that the premiums received by the company will be invested and earn interest which, when added to the accumulated premiums, will be sufficient to pay the policyholders' claims as they accrue. The rate of interest assumed in determining premiums is also employed in computing the "reserve" for policyholder claims which State law normally requires the company to maintain. The reserve is computed as that amount which, with an annual growth at the assumed rate of interest, will be sufficient (with the future premiums) to pay the actuarially-predicted policyholder claims. The mortality tables and the assumed rate of interest used in the computations are regulated by State law, and if the net assets of the company fall below the reserve so computed, the company is deemed insolvent and may no longer continue in business.

Since the reserve is computed by "discounting" the predicted policyholder claims to the present at the assumed rate of interest, it is obviously necessary,

[2] The selection of "gain from operations" for the major exposition can also be justified on the ground that, if anything, it is the measure that has the greater impact on the company's final taxable income. Changes in "gain from operations" will always affect taxable income by at least 50% of the amount of the change, and sometimes (when it is less than "taxable investment income") by 100%. Changes in "taxable investment income," on the other hand, never affect taxable income by more than 50% of their amount, and sometimes (when it exceeds "gain from operations") not at all. See § 802(b).

if the reserve is to continue to measure the company's ability to meet its policyholder obligations, that the reserve be increased each year by an amount equal to the interest that it was assumed the assets represented by the reserve would earn. Thus, out of the income earned each year from the investment of the premium receipts, a certain portion must be "set aside" and added to the reserve to "fund" the anticipated policyholder obligations. It is the tax treatment of the annual additions to the reserve that gives rise to this litigation.

2. *The statute.*—The present statute continues in a new form the longstanding policy of Congress not to tax the portion of a life insurance company's income that is required to be set aside as an addition to the reserve. The statute initially provides that in computing "gain from operations", the "investment yield" (investment income less investment expenses) is to be divided between the "policyholders' share" and the "company's share." The amount allocated to the policyholders is equal to the assumed interest rate times the reserves (the "required interest," § 809(a)(2)) and thus represents the amount required to be added to the reserves to fund the predicted policyholder claims. The amount allocated to the company is simply the balance. The "policyholders' share" so determined is wholly excluded from the company's income and only the "company's share" enters into its "gain from operations." In short, the company is taxed only on the excess of the investment income over the amount required to be added to the reserves.

The total investment income is, of course, composed of many different kinds of income (dividends, royalties, rents, taxable interest, tax-exempt interest, *etc.*), and it is therefore further necessary to say of what kinds of income the "policyholders' share" and the "company's share" are to be deemed composed. The statute solves that problem by allocating each item of income pro rata between the two shares. Thus, if the required addition to the reserve is $800,000 and the investment yield for the year is $1,000,000, 80% of each item of income is allocated to the policyholders and excluded from the company's income. The $200,000 allocated to the company is deemed to be composed of the remaining 20% of each item of income and is taxed accordingly, with the appropriate deductions then being allowed for tax-exempt interest, intercorporate dividends, *etc.* If, for example, the $1,000,000 investment yield included $100,000 of tax-exempt interest, the company's $200,000 share of the total investment yield would be deemed to include $20,000 (*i.e.*, 20%) of the tax-exempt interest and would accordingly be reduced by that amount, leaving $180,000 to be included in gain from operations. The other $80,000 of tax-exempt interest is deemed to have been already excluded as a part of the policyholders' $800,000 share of the total income, so that no further exclusion on its account is required.[3]

[3] The method of computing "taxable investment income" is substantially identical except that, in determining the amount of income to be allocated to the policyholders (called the "policy and other contract liability requirements"), the reserves are multiplied, not by the assumed rate of interest (as in computing "gain from operations"), but by the rate of return

The necessary effect of the statutory formula is that the receipt of tax-exempt interest will cause the company's "gain from operations", and hence its tax liability, to be higher than it would have been if that interest had not been received. That may be seen by comparing the example just given ($1,000,000 investment yield including $100,000 of tax-exempt interest, which produces $180,000 of taxable gain from operations) with the result that would be reached if the tax-exempt interest were eliminated, leaving $900,000 of investment yield composed entirely of taxable items. Because the "required interest" is a fixed amount (reserves times assumed interest rate) determined without reference to investment yield, the amount allocated to the policyholders would still be the same $800,000 and only $100,000 would be left as the company's share to be included in "gain from operations." Thus the receipt of an additional $100,000 of income in the form of tax-exempt interest causes "gain from operations" to be increased by $80,000.

The explanation of that result is simple. Because the absolute amount of income allocated to the policy-

---

actually realized by the company from the investment of its assets (either during the current year or, if lower, during the past five years) (§ 805). The effect of using the earnings rate rather than the assumed rate is dampened, however, by a further adjustment which reduces the amount so determined by 1% for every tenth of a percentage point by which the earnings rate exceeds the assumed rate; if the earnings rate is less than the assumed rate, the amount is increased by the same ratio (§ 805(c)(1)(B)). The net effect is the same as though the reserves were multiplied by a rate somewhere in between the assumed rate and the earnings rate.

holders is a constant (equal to the "required interest"), the *fraction* of the investment yield that must be allocated to them decreases as the investment yield increases. To give the policyholders $800,000 requires 100% of an investment yield of $800,000; 88.9% of a yield of $900,000; and only 80% of a yield of $1,000,000. By increasing the investment yield, therefore, the receipt of tax-exempt interest reduces the fraction of all the other income that must be allocated to the policyholders, thus leaving a larger part of the other income to be included in the company's gain from operations. In short, the reason that the receipt of tax-exempt interest causes an increase in tax is simply that it provides a larger base out of which the fixed claims of the policyholders can be satisfied, thus reducing their claims against the taxable items of income.[4]

Having defined "gain from operations" in a way necessarily causing it to be increased upon the receipt of municipal bond interest—the inevitable result of the pro rata allocation of such interest between the "policyholder's share" and the "company's share"—the statute concludes with the "exception" clause on

---

[4] The described consequences are those of the receipt of *additional* income in the form of tax-exempt interest. Very different is the case of a *substitution* of tax-exempt income for taxable income, which results instead in a decrease in tax fully commensurate with the extent to which the company's taxable income is taxed. With a fully taxable investment yield of $1,000,000 and a policyholder's share of $800,000, only 20% of the investment yield would be included in gain from operations. Commensurately, gain from operations would be reduced by 20% of any part of the investment yield that was shifted from taxable income to tax-exempt income.

which the decision below was based. That clause (§ 809(b)(4)) provides that:

> If it is established in any case that the application of the definition of gain from operations * * * results in the imposition of tax on [municipal bond interest, *inter alia*] * * *, adjustment shall be made to the extent necessary to prevent such imposition.

3. *Facts and proceedings below.*—During 1958, respondent received interest on municipal bonds in the amount of $36,637. Its total "investment yield," including that interest, was $894,277. The "required interest" on its reserves was $781,540 (App. 6a).

In its income tax return for 1958, respondent computed its "gain from operations" in accordance with the statutory definition. A part of the investment yield ($894,277) equal to the required interest on the reserves ($781,540) was excluded as the "policyholders' share," leaving $112,737 as the "company's share." The company's share, being 12.6% of the total investment yield, was treated as including 12.6% of the municipal bond interest, or $4,619. A deduction was taken for that amount, leaving $108,118 as the net investment income to be included in gain from operations.

In its claim for refund and in the proceedings below, respondent contended that the application of the statutory definition "result[ed] in the imposition of tax on" its municipal bond interest because it resulted in a higher gain from operations (and hence tax) than there would have been if it had not received the tax-exempt interest. To prevent that result, it contended that its gain from operations should be recomputed

under the "exception" clause by eliminating the municipal bond interest from the "investment yield" at the outset, reducing the investment yield to $857,640. The same amount would then be excluded as the "policyholders' share" ($781,540), leaving only $76,100 as the net investment income to be included in gain from operations. The resulting $32,018 reduction in gain from operations is exactly equal, it may be seen, to the portion of the municipal bond interest (87.4%) which the statutory formula allocated to the policyholders. The essential difference in the computations is that the statutory formula treats the amount allocated to the policyholders as consisting of a pro rata part of every item of income, including municipal bond interest, while respondent's computation allocates to the policyholders only taxable items of income and allocates all of the municipal bond interest to the company.

The district court held that respondent was not being taxed on its municipal bond interest under the statutory definitions and denied the refund. The court of appeals reversed. It construed this Court's decisions in *National Life Insurance Co.* v. *United States,* 277 U.S. 508, and *Missouri Insurance Co.* v. *Gehner,* 281 U.S. 313, as meaning that a tax is unconstitutionally imposed "on" tax-exempt interest whenever "the liability of the taxpayer is increased, solely by reason of the receipt of tax-exempt interest" (App. 20a). By that standard, a tax was being imposed "on" respondent's municipal bond interest, since its tax was greater than it would have been if that interest had not been received. Since the court

considered itself bound by the *National Life* and *Gehner* decisions as to what constitutes a tax "on" tax-exempt interest, and since any challenge to the constitutional immunity of municipal bond interest from taxation was pretermitted by the "exception" clauses of the statute, the court held that respondent was entitled to adjust its tax, under the "exception" clauses, to what it would have been if the municipal bond interest had not been received. Specifically, the court approved respondent's reduction of its "gain from operations" from $108,118 (the result under the statutory definitions) to $76,100 (the result under respondent's method of computation described above).

REASONS FOR GRANTING THE WRIT

The decision of the court below, in what is regarded as a "test case" by the life insurance industry, strikes down a carefully formulated statutory plan for the taxation of life insurance companies. It will subject the government to as many as 8,000 claims for refund of approximately $400,000,000 for the years 1958–1964. For the future, the decision, if followed, would cause a revenue loss of several hundred million dollars a year.

1. Since 1921 Congress has wrestled with the relationship between the tax exemption of interest on obligations of a State (or State subdivision) and the deduction or exclusion of income attributed to a life-insurance reserve held for policyholders. In 1959, after prolonged hearings and consultation with all the interested parties and after unusually detailed

Congressional consideration, Congress enacted an elaborate new plan of taxation of life insurance companies. Adoption of the statute was urged by life insurance companies holding more than 70 percent of all life insurance company assets (105 Cong. Rec. 8401–8402) as well as by the Treasury Department.

That carefully devised plan has been nullified by the decision below. Its cornerstone is the treatment of the excluded "policyholders' share" as consisting of a pro rata part of each item of income, including tax-exempt interest, thus leaving in the company's hands, to be claimed as a further deduction, only the remaining fraction of the tax-exempt interest. Since the receipt of additional tax-exempt interest does not increase the exclusion for the policyholders' share of the total income, and increases the deduction for tax-exempt interest only by a fraction of its amount, the receipt of such interest necessarily causes a net increase in the company's "gain from operations" and hence its tax liability. That occurs, not because of any circumstance peculiar to this case, but because it is inherent in—and was the intended result of—the statutory definition of "gain from operations." The holding of the court below that a tax is imposed "on" tax-exempt interest, requiring an adjustment under the "exception" clause, whenever the receipt of tax-exempt interest causes the tax to be higher thus wholly destroys the statutory plan. Its effect is to strike from the statute the elaborate formula for the division of each item of income between the "policyholders' share" and the "company's share" and to

substitute in every case a judge-made "adjustment" under the "exception" clause.[5]

The holding below is no less an effective invalidation of a provision of an Act of Congress than would have been a holding that the statute was unconstitutional—which was, indeed, the context in which the cases relied upon by the court below arose. The only difference is that the "exception" clause precludes any challenge to the immunity of State and

[5] It is admitted that the same result will *normally* occur also under the definition of "taxable investment income", but whether it will *necessarily* occur depends upon what assumptions are made in computing what the taxable investment income "would have been" without the tax-exempt interest. "Taxable investment income" computed under the statutory definition will always be greater than it would have been if the company had not had the municipal bonds. It will usually, but not necessarily always, be greater than it would have been if the company had had the bonds but had not received the interest, which is the assumption respondent and the court of appeals employed in recomputing respondent's taxable investment income. Leaving the bonds in the company's assets but removing the interest from the investment yield causes a marked reduction in the earnings rate (investment yield divided by assets) and thus in the amount of income allocated to the policyholders (reserves times earnings rate, see note 3, *supra*). The reduced exclusion for the policyholders' share tends to offset the reduction in the investment yield, and in extreme circumstances can wholly offset it. The justification for using wholly disparate factors in computing the earnings rate (dividing both taxable and exempt assets into the income from the taxable assets alone) is not apparent, however. Nor is it apparent why respondent and the court below are willing to tolerate the inclusion of tax-exempt bonds in the asset account when the effect is to increase taxable investment income. By the court of appeals' standard, that results in imposing a tax "on" the bonds themselves which, if anything, is surely more objectionable than imposing a tax merely on the interest from the bonds.

municipal bonds from taxation. Fearful that a full defense of the constitutionality of its statute might involve an attack upon the whole doctrine of intergovernmental immunities, and wishing to preserve the basic immunity of municipal bond interest regardless of constitutional compulsion, Congress postulated that a tax on municipal bond interest was constitutionally impermissible and left open for litigation only the question whether the taxing plan it adopted imposed a tax "on" such interest. But while the question is presented in the context of a statutory caveat, avoiding the necessity of an ultimate decision of constitutionality, it cannot rightly be seen as a question of statutory interpretation in the usual sense. Since Congress obviously did not "intend" by the exception clause to retract the taxing formula it simultaneously enacted, the question whether the statute imposes a tax "on" municipal bond interest cannot be answered by asking what Congress meant by "on." In essence, the exception clause asks a hypothetical constitutional question and says what shall happen if the question is answered adversely to the statutory formula. The question is: Assuming the continuing vitality of the doctrine that a tax may not constitutionally be imposed on the interest from State and municipal bonds, would this statute be unconstitutional as imposing such a tax? If the answer is "yes", the statute provides a remedy and

thus precludes any challenge to the premise of that question.[6]

But whether seen as a statutory or a quasi-constitutional decision, the fact remains that the decision renders nugatory and unenforceable the key feature of the Life Insurance Company Income Tax Act of 1959—to wit, the division of each item of income pro rata between the "policyholders' share" and the "company's share." In the place of the pro rata allocation of the statute, the decision requires that 100% of the municipal bond interest be allocated to the company and that only taxable items of income be allocated to the policyholders. And since that is said to be the only treatment consistent with the postulated immunity of municipal bond interest from taxation, the decision would force Congress to continue to use that method of allocation in any future legislation, however arbitrary it may seem, unless it is willing directly to assert a power to tax municipal bond interest. In the present statute, Congress carefully avoided a test of that power, believing that it could tax life insurance companies in the manner attempted in the Act without impinging upon the supposed immunity of interest on

[6] In addition to pretermitting the question of immunity *vel non*, the "exception" clause performs a second important function. When the predecessor statute was held unconstitutional in the *National Life* case, there was left a difficult question whether the consequence should be to strike down the whole taxing statute, the entire deduction for additions to the reserve, or only the limitation on the deduction (see 277 U.S. at 534–535 (Brandeis, J., dissenting)). The "exception" clause of the new statute avoids that problem by providing statutory authority for a judicial "remodeling" of the statute should it be held "unconstitutional" as written.

governmental obligations from taxation by another sovereign. Congress, we submit, is entitled to the judgment of this Court on the correctness of that belief before it is remanded to the hard choice between either (a) allowing life insurance companies to enjoy what it reasonably considers to be a doubling up of tax benefits or (b) precipitating a major constitutional decision on the power of the Federal and State governments to tax the interest paid on each other's obligations.

2. Staggering amounts of revenue turn upon the issue. The Treasury estimates that acceptance of the decision below would render the United States subject to $400,000,000 in refund claims with respect to tax-exempt interest and the dividends-received deduction for the years 1958–1964.[7] The amounts estimated to be involved for future years range from a figure of about $77,000,000 in 1965 (on the assumption that the companies' proportionate holdings of tax-exempt bonds and corporate stocks remain at their present level) to an annual figure of $325,000,000 by 1970 (on the assumption that the companies undertake to minimize their future tax liabilities by adjusting the holdings in their portfolios). *Hearing Before The Senate Committee On Finance on H.R. 5739,* 88th Cong., 2d Sess., pp. 28–29.

---

[7] Of the estimated revenue loss of $400,000,000 for the period 1958–1964, $180,000,000 is attributed to adjustments for tax-exempt interest and $220,000,000 to adjustments for corporate dividends received by life insurance companies. Sections 804 (a)(6) and 809(b)(4) require adjustments to prevent the "imposition of tax" not only with respect to tax-exempt interest, but also with respect to dividend income which qualifies for the "dividends received" deduction under §§ 243–245.

The volume of litigation threatened to be precipitated is almost equally imposing. The Treasury estimates that the decision below will result in up to 8,000 refund claims for past years alone, unless it is reviewed and the issue resolved with finality by this Court. It is thus of the greatest administrative, as well as fiscal, importance that this Court review the decision of the Tenth Circuit.

3. A decision of a lower court effectively invalidating a Congressional plan of taxation so plainly calls for review by this Court that an extended discussion of the merits is neither necessary nor appropriate. To show that the question is substantial, however, we will briefly indicate the nature of the issues.[8]

a. There is no dispute in this case as to how the statutory formula operates or the effect the receipt of tax-exempt interest has under it. The only question is: when is a tax a tax "on" municipal bond interest? The court of appeals' answer is a simple one: whenever the tax is greater than it would have been if the taxpayer had not received the tax-exempt interest, the amount of the increase in the tax is a tax "on" tax-exempt interest. In our view, that answer is too simple, and wholly fails to appreciate the essential ambiguity in identifying a tax determined by a computation involving many elements with any one of the elements. Suppose that a company has a $1,000,000 investment yield composed of $200,000 of each of five kinds of income: municipal bond interest, industrial bond interest, dividends, royalties, and rents. If the amount excluded as the policyholders'

---

[8] For a fuller treatment, see Wurzel, *Tax-Exempt Interest of Life Insurance Companies*, 70 Yale L. J. 15 (1960).

share were $800,000, the court below would say that the entire tax determined under the statutory formula was a tax "on" the municipal bond interest, because without it there would have been no tax. But employing precisely the same reasoning, one can prove just as conclusively that the entire tax was "on" the dividends, or "on" the rents—in short, that it was "on" whichever one of the items one chooses to assert that it was on. The fact is that without any one of the items there would have been no tax, and the answer simply cannot be found, as the court of appeals tried to find it, in the rules of arithmetic.[9] Rather, like most questions of constitutional power, the answer must be found, not in mathematical abstractions, but in the reasonableness of the classifica-

[9] To demonstrate the same ambiguity in the context of the allocation of income between two shares, suppose that a trust has $10,000 income composed in equal parts of five kinds of income with differing tax consequences (capital gains, depletable income, tax-exempt interest, domestic dividends, and foreign tax-paid dividends). Under the trust instrument, the first $6,000 of income is to be distributed to *A*, the balance, which happens to be $4,000 in the year in question, to *B*. For tax purposes, which beneficiary receives which income? Must *B* be treated as receiving all of the tax-exempt interest because it is his share, and not *A*'s, that would have been reduced had it not been received (a statement equally true of each of the other kinds of income)? The statutory solution, not surprisingly, is identical to that adopted for life insurance companies: *A*, having received 60% of the total income, is deemed to have received 60% of each item (§ 662(a)(1) and (b)). Since the result is to make *B*'s tax greater than it would have been if the trust had not received the tax-exempt interest, is *B* being taxed "on" tax-exempt interest under the rationale of the court below? If the fact that *A* is also taxable be thought significant, would it make a difference if *A* had happened to be an exempt organization?

tions of income and the rules for attribution of expenses adopted by Congress.

In our view, the statutory formula is a reasonable exercise of Congress' power to classify income and expenses regardless of whether the addition to the reserve is treated as a division of income between co-beneficiaries or as a cost of producing income. If the policyholders are treated, on a trust analogy, as having a beneficial interest in the undivided part of the assets represented by the reserve liability, it can hardly be considered unreasonable to attribute to them a pro rata part of all the kinds of income derived from the investment of those assets. If, on the other hand, the addition to the reserve is viewed as a deduction representing a deferred cost incurred by the company in exchange for the use of the funds advanced to it by policyholders as premiums—represented by the reserve—the formula is still reasonable. Congress need not allow deductions for the "cost" of producing income which is itself tax-exempt. *Denman* v. *Slayton*, 282 U.S. 514. The question then is, which income was produced by the investment of the reserve funds "borrowed" from the policyholders at the "cost" of the annual addition to the reserve? There being no more reason to trace the "borrowed" funds into one kind of asset than another, it is surely both reasonable and fair—and within the competence of Congress—to treat the reserve funds as being used to buy and carry an equal fraction of all the assets, thus justifying a proportional denial of the deduction for the "cost" of using those funds (*i.e.*, in the same

proportion as the company's total funds are invested in producing tax-exempt interest).

b. So plainly reasonable is the method of allocation adopted by Congress that the only substantial question posed by this case is the scope to be given to the decisions in *National Life Insurance Co.* v. *United States,* 277 U.S. 508, and *Missouri Insurance Co.* v. *Gehner,* 281 U.S. 313. If the opinions in those cases are read for the most that their language implies, they admittedly lend support to the decision below. Yet not only has the continuing vitality of those decisions—rendered over dissents by Justices Holmes, Brandeis and Stone (endorsed in principle by Chief Justice Hughes, see 281 U.S. at 322)—been cast in doubt by intervening developments in the law of inter-governmental immunities, but they are readily distinguishable on their facts and can hardly be deemed controlling here.

In *National Life,* the statute allowed a deduction for additions to the policyholders' reserves only to the extent that the additions exceeded the tax-exempt interest. It thus suffered from the same vice that characterizes the decision below: instead of a pro rata allocation, it arbitrarily allocated 100% of the tax-exempt interest to the reserves, just as the decision below arbitrarily allocates 100% of the tax-exempt interest to the company. The *Gehner* case, in turn, involved the invocation of the federal immunity from State taxation, an immunity which this Court has recognized to be broader than the immunity enjoyed by the States from federal taxation. See *New York* v. *United States,* 326 U.S. 572, 576–577. Just as im-

portantly, it involved a tax on property rather than one on income. A tax on the interest paid on bonds is already one step removed from a tax on the bonds themselves, and a tax the measure of which is affected by the interest received from tax-exempt bonds (this case) is therefore one step removed from a tax the measure of which is affected by the tax-exempt bonds themselves (*Gehner*).

The present statute, moreover, rather than limiting a deduction otherwise allowable (as did the statutes in those cases), treats a share of each item of income as "belonging" to the policyholders and therefore never includes that portion in the company's income. It may be that a truly sophisticated analysis (viewing deductions as equally an "appropriation" of income, albeit to pay "costs" rather than claims of beneficiaries) would see little difference between allocating items of income among beneficiaries and allocating deductions to items of income. If so, it would only reveal a lack of sophistication in the reasoning of *National Life* and *Gehner*, for there can be no quarrel that, at least in dividing income among co-beneficiaries, a pro rata allocation of each item of income is the only solution that has any claim to reason (see note 9, *supra*). Whether the income-division approach of the present statute serves to distinguish the prior cases or only to expose their fallacies, it makes evident the reasonableness of the statute's method of allocation, from which the conclusion that no tax is being imposed on municipal bond interest follows automatically.

CONCLUSION

For the reasons stated, this petition for a writ of certiorari should be granted.

Respectfully submitted.

ARCHIBALD COX,
Solicitor General.

LOUIS F. OBERDORFER,
Assistant Attorney General.

WAYNE G. BARNETT,
PHILIP B. HEYMANN,
Assistants to the Solicitor General.

JOHN B. JONES, JR.,
GILBERT E. ANDREWS,
Attorneys.

SEPTEMBER 1964.

APPENDIX A

UNITED STATES COURT OF APPEALS
TENTH CIRCUIT

March Term, 1964

No. 7424

ATLAS LIFE INSURANCE COMPANY, APPELLANT

vs.

UNITED STATES OF AMERICA, APPELLEE

APPEAL FROM THE UNITED STATES DISTRICT COURT FOR THE NORTHERN DISTRICT OF OKLAHOMA

May 25, 1964

Before MURRAH, *Chief Judge,* and BREITENSTEIN and HILL, *Circuit Judges*

MURRAH, *Chief Judge.*

The taxpayer, a life insurance company, appeals from a judgment of the District Court (Atlas Life Insurance Co. v. United States of America, 216 F. Supp. 457), denying refund of income taxes paid by it, pursuant to the Life Insurance Company Tax Act of 1959. 26 USC 801 et seq. The Act imposes a tax at ordinary corporate rates upon "life insurance com-

743-750—64——4

pany taxable income" (§ 802(a)), based upon a three-phase calculation under Section 802(b), which, for our purposes, involves only the first two steps, namely: the determination of "taxable investment income" and "gain from operations" as defined in Sections 804 and 809, respectively.

The taxpayer computed and paid its income taxes for the year 1958 in accordance with the statutory definitions. It thereafter filed claim for refund, contending that the application of the statutory definitions "taxable investment income" and "gain from operations" resulted in the imposition of a tax on tax-exempt interest received from municipal bonds, and that it is therefore entitled to an adjustment under the provisions of Sections 804(a)(6) and 809(b)(4).

The Act of 1959 was promulgated in response to the recognized need for a more permanent and equitable method for determining taxable income of life insurance companies, and was the result of a comprehensive reappraisal of former legislation in the area. The formula for the determination of the tax was conceived in recognition of two salient principles of tax immunity: (1) the policy which has inhered in income tax law since its inception in 1913, to the effect that interest on state securities is excluded from gross income in the computation of the taxpayer's federal tax liability;[1] and (2) in recognition of the traditional concept that a life insurance company should not be taxed on that part of its income which is required to be set aside as a reserve to meet the company's contingent obligations to its policyholders. See 2 USC, Congressional and Administrative News, 86th

[1] This concept is presently embodied as a general rule in Section 103, 26 USC Sec. 103, but is not applicable to the tax treatment of life insurance company tax-exempt interest.

Congress, First Session, 1575; Wurzel, "Tax-Exempt Interest of Life Insurance Companies", 70 Yale L.J. 15 (1960).

The concept of "reserve deduction" is perpetuated in the Act by the division of each and every item of net investment income into two catergories; (1) the policyholders' share which is excluded from tax liability; and (2) the Company's share which is subject to taxation. To effectuate the division of the Company's share from the policyholders' share of the net investment income, the Act first provides for the determination of net investment income, i.e., "investment yield", or gross investment income, including tax-exempt interest, less certain expenses. See §§ 804(c), 804(a)(1) and 809(a)(1). The policyholders' percentage share of investment yield is determined by dividing investment yield into "policy and other contract liability requirements." § 804(a)(1). These requirements are calculated in accordance with the complicated formula provided in Section 805 by adding: the product of the company's "adjusted reserves rate"[2] and its "adjusted life insurance reserves";[3] the

[2] The "adjusted reserves rate" is the lower of the average earnings rate or the current earnings rate. § 805(b)(1) The "current earnings rate" is the investment yield divided by the mean of the company's assets. § 805(b)(2) The "average earnings rate" is the average of the current earnings rates for the taxable year and for each of the four preceding taxable years. § 805(b)(3).

[3] The "adjusted life insurance reserves" is the mean of life insurance reserves, other than pension plan reserves, adjusted upward by one percent for every tenth of a percent by which the "adjusted reserves rate" is less than the assumed interest rate used in calculating such reserves. If the "adjusted reserves rate" exceeds the assumed interest rate, the reserves are adjusted downward in a similar manner. § 805(c).

pension plan reserves multiplied by the current earnings rate;[4] and interest paid. The percentage derived from the use of this formula[5] represents the policyholders' percentage share, and the remaining portion of 100 percent is the company's percentage share. The life insurance company's percentage share of each and every item of investment yield is then reduced by its percentage share of tax-exempt interest,[6] and the result is taxable investment income.

The second phase for calculating the base tax, i.e., "gain from operations", follows a similar pattern in determining the policyholders' share of investment yield. Though the formula is different,[7] it is sufficient for our purposes to note that, as in phase one, the tax-exempt interest is included to determine the respective percentage shares, and the company's share of exempt interest is then deducted to arrive at gain from operations. See § 809. Thus, after the computation of tax-

---

[4] See Footnote 2 for explanation.

[5] It is important to note that investment yield which includes tax-exempt interest is not only the denominator of this formula, but it also significantly affects the determination of the numerator.

i.e. $\frac{\text{policy and other contract liability requirements}}{\text{investment yield}}$

And See Footnotes 2 and 3.

[6] Other deductions are specified in § 804(a)(2)(A).

[7] The policy holders' percentage share of gain from operations is determined by dividing "investment yield" into "required interest" as defined in Section 809(a)(2) instead of "policy and other contract liability requirements." The company's share of each and every item of "investment yield" is then added to the net premium receipts which is reduced by specified deductions, including the company's share of tax-exempt interest. See § 809(d). The result is "gain from operations."

able investment income and gain from operations, Section 802(b) specifies their proper relationship to determine "life insurance company taxable income", i.e., the sum of taxable investment income and 50 percent of the excess of gain from operations over taxable investment income.

The Act then finally provides as an "exception" that "if it is established in any case that the application" of the definitions of taxable investment income and gain from operations "results in the imposition of tax on" any tax-exempt interest, "adjustment shall be made to the extent necessary to prevent such imposition." §§ 804(a)(6) and 809(b)(4).

Making application of the statutory formula in its return for 1958, the taxpayer first computed its tax liability to be $62,615.05. And, it does not now dispute the correctness of the calculations of its tax liability under the formula. The contention is rather that the application of the formula results in its tax liability being increased by $11,252.19, solely because of the receipt of tax-exempt interest and its inclusion in the determination of the tax base. The claim for refund is based on computation of the company's tax liability without the inclusion of tax-exempt interest in investment yield as used in the formula for determining the tax base.

An interpretative analysis of the table below[8] reveals the extent to which the inclusion or exclusion of

[8] This table illustrates the differential in the company's tax liability under the statutory formula and the taxpayer's computations of its liability based upon the exclusion of the tax-exempt interst from investment yield whenever it becomes operative under the formula. Neither party disputes the correctness of the arithmetic computations which reflect the

tax-exempt interest in or from investment yield permeates the whole computation of tax liability. Thus, in phase one, a reduction of the adjusted reserves rate results because it is the lower of the two earnings rates, which are in essence determined by dividing assets into investment yield. See Footnote 2. The effect of the reduction in the adjusted reserves rate on policy and other contract liability requirements is par-

---

application of their respective theories of the company's statutory tax liability.

Phase 1: Computation of Taxable Investment Income

Item	Statutory formula	Exempt interest excluded
Investment Yield	$894,277.61	$857,639.82
Current Earnings Rate	3.33390%	3.19731%
Average Earnings Rate	3.253782%	3.12297%
Adjusted Reserve Rate	3.253782%	3.13397%
Adjusted Life Ins. Reserves Rate	$22,090,965.28	$22,375,659.00
Policy & Other Contract Liability Requirements	$763,144.28	$743,137.55
Policyholders' Percentage Share	85.3364%	86.6491%
Company's Percentage Share	14.6636%	13.3509%
Company's Share of Items of Investment Yield	$131,133.29	$114,502.27
Deduction of Tax-Exempt Interest	$5,372.42	none
Taxable Investment Income	$100,760.87	89,502.27

Phase 2: Computation of Gain from Operations

Item	Statutory formula	Exempt interest excluded
Investment Yield	$894,277.61	$857,639.82
Required Interest	781,540.32	781,540.32
Policyholders' Percentage Shares	87.39348%	91.1269%
Company's Percentage Share	12.60652%	8.8731%
Company's Share of Items of Investment Yield	$112,737.29	$76,099.50
Deduction of Tax-Exempt Interest	$4,618.75	none
Gain from Operations	$161,220.08	$129,201.04

Tax Computation

Item	Statutory formula	Exempt interest excluded
Taxable Investment Income	$100,760.87	$89,502.27
50% of the Excess of Gain from Operations over Taxable Investment Income	30,229.61	$19,849.39
Life Insurance Co. Taxable Income	$130,990.48	$109,351.66
Total Income Tax*	$62,615.05	51,362.86

*The $11,252.19 differential constitutes the claimed refund.

tially offset by the increase in the adjusted life insurance reserves caused by the greater difference between the adjusted reserves rate and the assumed interest rate. See Footnote 3. Although policy and other contract liability requirements are lower, the policyholders' percentage share is greater because of the exclusion of the exempt interest from investment yield. Conversely, the Company's percentage share is greater because of the inclusion of exempt interest in investment yield. Thus, the percentage differential and the ultimate increase of taxable items of investment yield included in taxable investment income are attributable to the inclusion of tax-exempt interest.

Similarly, in the phase two computation, exclusion of tax-exempt interest from investment yield results in an increased policyholders' percentage share, because it is calculated by dividing investment yield into required interest which remains the same. Thus, the difference in the Company's percentage shares is attributable to the inclusion of the exempt interest, and this in turn accounts for the variation in gain from operations.

The trial court's conclusion that the receipt by the taxpayer of exempt interest was not in fact taxed, is apparently based upon the interpretation of the statutory formula, to the effect that the "company's tax-exempt interest is included in gross income and then deducted before reaching the tax base of the Taxpayer." Atlas Life Insurance Co. v. United States of America, supra, p. 460. The fallacy of this interpretation is that it fails to recognize what the Government seems to concede, that the increase in the Company's share of investment yield by the inclusion of exempt interest in the formula for determining the respective percentage shares is not offset by the deduction of the Company's percentage share of exempt

interest, and that the ultimate tax liability is in fact increased.

The judgment of the trial court is sought to be sustained on the theory that although the inclusion of tax-exempt interest in the formula results in an increase in the Company's share of all other income, it will be exactly what it would have been if the Company had received taxable income, and that the application of the statutory definitions does not therefore result in a tax on tax-exempt interest. The Government says this is "precisely what Congress intended." And, they justify it by emphasizing the design of the statute to divide the ownership of all investment income, and that this has the concomitant effect of dividing the tax-exempt interest between the policyholders and the Company. This method of prorating the exempt interest is said to be an exertion of the "full power" of Congress to classify income for tax purposes, and in this particular case, to prevent a double deduction through the interplay of the exclusion of the policyholders' share and the deduction of exempt interest.

The Government attacks the taxpayer's formula which eliminates the exempt interest from the computation as in effect allocating all taxable dollars to the policyholders and all tax-exempt dollars to the Company, thus creating a loophole which the statute was designed to prevent.

If, as the Government contends, the Congress, in enacting the taxing formula, intended to test anew the doctrine of inter-governmental tax immunity by exerting its full constitutional powers to classify income for tax purposes, our inquiry is simply whether, judged by present-day concepts, the Congress overstepped its constitutional bounds. But, the taxpayer takes the position that Congress legislated with an

eye to the doctrine of National Life Insurance Co. v. United States, 277 U.S. 503; and Missouri v. Gehner, 231 U.S. 313, according to which the sovereign may not subject a taxpayer to a greater burden on his income solely because of the receipt of tax-exempt interest. As we view our lawsuit in the context of the respective contentions of the parties, it involves the determination of the extent to which the Congress intended to exercise its power of taxation with respect to tax-exempt interest received by life insurance companies.

While resort to legislative history is usually justified only in cases of ambiguity in the statutory language, i.e., see Nicholas v. Denver & R.G.W. R. Co., 195 F. 2d 428, it is frequently relied upon for the ascertainment of a Congressional purpose as embodied in the final enactment. See Flora v. United States, 362 U.S. 145; United States v. Harriss, 347 U.S. 612; United States v. American Trucking Assn., 310 U.S. 534; Caminetti v. United States, 242 U.S. 470; Sutherland on Statutory Construction, Vol. 2, p. 481 et seq. In the words of Mr. Justice Frankfurter, dissenting in Reed v. Pennsylvania RR Co., 351 U.S. 502, 510, "The process of judicial construction must be mindful of the history of the legislation, of the purpose which infused it, of the difficulties which were encountered in effectuating this purpose, of the aims of those most active in relieving these difficuties." To support their positions, both the Government and the taxpayer rely heavily on the extensive legislative history of the Act as influenced by the contemporary case law. We will therefore examine it to determine the purpose and scope of the taxing act.

The parties start with the Revenue Act of 1921 and particularly Section 245(a), 42 Stat. 227, 261, which provided that in the case of life insurance companies,

net income means gross income less certain deductions, inter alia, (1) the amount of interest received from tax-exempt securities; and (2) a reserve deduction reduced by the amount of exempt interest. In National Life Insurance Co. v. United States, supra, the Supreme Court held that the diminution of the reserve deduction by the amount of exempt interest had the effect of destroying the guaranteed exemption. The underlying principle, as announced by the Court, was to the effect that a taxpayer may not be subject to a greater tax burden on his taxable income solely by reason of the receipt of tax-exempt interest.

There were strong and persuasive dissents in which it was suggested that since the reserve deduction was a matter of grace or bounty, the Congress was perfectly free to reduce it by the amount of exempt interest, or any other amount for that matter. The dissenters did not think that the Constitution or the laws guaranteed that "a holder of tax-exempt bonds, shall be better off than if he held only taxable securities"; nor did it require that "those who do not hold tax-exempt securities shall, in respect to every tax, be subjected to a heavier burden than the owners of tax-exempt bonds." National Life, supra, p. 528.

Apparently, on the authority of National Life, the Supreme Court in Missouri v. Gehner, supra, reversed the Missouri Supreme Court which, in considering a state property tax, had upheld the apportionment of reserves and claims between taxable and non-taxable assets, including United States bonds. The Court restated the National Life doctrine to the effect that a "State may not subject one to a greater burden on his taxable property merely because he owns a tax-exempt government securities." Missouri v. Gehner, supra, p. 321. The same dissenters, speaking through Mr. Justice Stone in Gehner, were of the opinion that

nothing in National Life required a reversal of this case. They insisted that tax-free securities might well be realistically held accountable for their share of reserves for claims in computing the tax. Otherwise, said they, an affirmative benefit is conferred upon the ownership of tax-exempt securities "at the expense of the taxing powers of the state, by relieving the owner from the full burden of taxation on net worth to which his taxable assets have in some measure contributed." Gehner, supra, p. 328. It would thus appear that the dissenters would have given little or no respect to the doctrine of intergovernmental tax immunity. In any event, it seems reasonable to say that the same vigorous dissenters in both National Life and Gehner would find no fault in the asserted power to apportion tax-exempt income between the reserve deduction and taxable income for the purpose of arriving at the taxpayer's tax liability.

Another contemporary decision of the Supreme Court, Denman v. Slayton, 282 U.S. 514, also involved the 1921 taxing Act, particularly Section 214(a)(2), 42 Stat. 227, 239, which denied a deduction for interest paid on indebtedness incurred to purchase or carry tax-exempt securities. In his return for the taxable year 1922, the taxpayer excluded interest received on tax-exempt muncipal bonds and deducted the interest on money borrowed to purchase and carry the bonds. The Commissioner disallowed the deduction and the lower court sustained the taxpayer on the authority of National Life. But, a unanimous Supreme Court, in an opinion by the writer of National Life, held that National Life was "radically different", and that its doctrine did not control. The Court went on to say that "while guaranteed exemptions must be strictly observed, this obligation is not inconsistent with reasonable classification designed to subject all to the

payment of his just share of a burden fairly imposed." Denman v. Slayton, supra, p. 519.

Such was the state of the decisional law as Congress continued to wrestle with the problem of finding a just and appropriate method of determining life insurance companies' taxable income. The 1921 Act apparently was not amended to reflect the National Life restriction on reserve deduction until the 1932 Act, which simply deleted the objectional provision for diminution of the reserve deduction by the amount of exempt interest. 47 Stat. 169, 224; § 203 of Revenue Act of 1932. This text of the law was carried forward and observed until 1942 when a new system was introduced. 56 Stat. 798, 868–870, §§ 202 and 203 of the Revenue Act of 1942. This Act prescribed a reserve deduction expressed as a percentage of investment income, including tax-exempt interest based on industry-wide experience. Each company applied this percentage to its net investment income, but was allowed to deduct all its tax-exempt interest before prorating its net investment income.

As in our formula, the 1942 Act included exempt interest in its formula for determining the industry-wide reserve deduction percentage. And, this percentage, which was applied to determine the individual company reserve deduction, was decreased by the inclusion of tax-exempt interest. This had the theoretical effect of increasing the percentage of net investment income which is taxable. But no taxpayer was induced to test the added tax burden as against the doctrine of National Life, apparently for two reasons: (1) the industry-wide reserve deduction percentage was so great that the individual company's net taxable investment income was minuscule; (2) each company could minimize its tax burden by purchasing tax-exempt securities because the income

therefrom was not included in the computation of their individual tax liability. This situation obtained without significant change until 1958. See Wurzel, Yale L.J., supra, p. 20–21.

After considerable study, the House passed a Bill which provided for the determination of insurance company tax liability in three steps on an individual company basis. The step one base was the difference between the taxable net investment income, as reduced by the total amount of exempt interest, and the reserve deduction, as reduced by its allocable share of exempt interest. See: §§ 804 and 805, H.R. 4245, Hearings Before Senate Finance Committee on H.R. 4245, 86th Cong., First Sess. (1959), pp. 4–7. The provisions of the House Bill in this regard are noticeably similar to the so-called "Add-Back" provisions of Section 245(a)(2) of the 1921 Act, the distinction being that the reserve deduction was not diminished by the total amount of exempt interest, but only its prorata share. It is also noteworthy that the mathematical result of the House formula is conceded by all parties to be identical with the result obtained in the final Act.[9] The insurance companies apparently did not detect the shades of the 1921 Act in the House Bill until it came before the Senate. It was then that they apparently became aware that their tax liability might be increased solely by reason of the receipt of tax-exempt interest.

When the Treasury came before the Senate Finance Committee to urge the adoption of the House Bill, the Treasury witness, explaining the provisions of the proposed legislation, observed that while the tax-exempt interest was excluded in both phases of the

[9] The formula for step 2 proceeded along the same lines and, with a result also identical to the final Act. See: § 809, H.R. 4245, Hearings, supra, pp. 8–10.

Bill, an adjustment was made "to the deductions to avoid a double benefit * * *." He also agreed that it was "probably a fair statement" to say that the adjustment was in reality charging a part of the operating expense against tax-free interest. When asked why the Treasury proposed to tax-exempt interest, "even partially", the witness candidly answered: "Because we think it is right." In answer to further queries whether such a provision would render the bill unconstitutional, the witness also candidly admitted that he thought the question "might very well be litigated", and that "we should determine with the best advice we can, as to whether or not we today think such a provision is unconstitutional, and if we believe it is not, and if we believe the provision is right, we ought to include it in the bill." Hearings, supra, pp. 43–44.

The extensive pro and con hearings before the Senate Finance Committee on the House Bill reflect strong representations on the part of insurance companies and those interested in the marketability of tax-exempt securities, to the effect that the proration of the tax-exempt interest between the reserve deduction and net investment income resulted in a tax burden on exempt interest, contrary to National Life, and was therefore constitutionally impermissible. In short, they rested their case principally on the constitutional limitations of National Life and Gehner.[10] There was the further strong representa-

[10] One witness, president of a large life insurance company, in his statement purported to represent 120 companies; "We believe that, in its treatment of tax-exempt interest, H.R. 4245 contravenes the decision of the Supreme Court in the case of National Life v. United States. We think that if it was unconstitutional to add back 100 percent of tax-free interest to the tax base under the 1921 law, then adding back only 70

tions that the resultant burden on the exempt security would adversely affect their marketability in competition with taxable securities—a result which Congress would wish to avoid."[11]

As we summarize the Government's representations to the Senate Committee, they were based primarily on the thesis that the trend of the recent Supreme Court decisions was away from the National Life doctrine of intergovernmental tax immunity, and toward the minority view; that in any event, the House Bill formula was unlike the 1921 formula, and in substance the same as the 1942 formula, which

---

percent of such interest is unconstitutional, too." Hearings, supra, p. 305. He also filed a lawyer's brief on the constitutional question. See Hearings, p. 308.

Another witness, vice-president of a life insurance company, stated that "As H.R. 4245 now stands, it is not possible for a life insurance company to invest either its capital or surplus funds in municipal bonds and receive the interest on them free from tax; at least, not unless it first invests all of its policyholders' reserve funds in municipal bonds. And this would be absurd." Hearings, supra, p. 406. He too supplemented his testimony with a memorandum on the constitutionality of taxation of tax-exempt interest, in which it was "observed that the pro rata disallowance rule under the Ohio (sic) statute which was held unconstitutional in the Missouri v. Gehner case is very similar to the pro rata rule contained in Section 809(d) of the present bill." Hearings, supra, 408.

See also: Hearings, supra, pp. 614, 632.

[11] The executive director of an association representing 13,000 municipal governments submitted a statement in which H.R. 4245 was characterized as "* * * the opening wedge to apply the same principal to all other taxpayers." It also noted the "* * * * higher interest rates which State and local governments would have to pay if such a Federal tax were imposed on all their bonds in the future." Hearings, supra, p. 699. An association composed of 6,000 county officials endorsed this statement. See Hearings, supra, p. 699–700.

See also Id., p. 106, 187–188, 252, 305, 405, 632, 687.

had the effect of preventing a double deduction for tax-exempt interest, and which had never been challenged in the courts. See: Hearings, supra, p. 48–51.

It is not manifestly clear what considerations prompted the Senate Committee to revise the House Bill, but the fact is that it did reapproach the problem somewhat differently with respect to the treatment of tax-exempt interest. One of the innovations deemed important in the Senate version was division of the ownership of income and expense items between the policyholders and the insurance company, with only the company's share being taken into account for tax purposes. See: 2 USC Cong. & Adm. News, supra, p. 1580. The Senate Committee seemed to think that by dividing ownership of investment income by the use of a formula which included all tax-exempt interest, and the deduction of the company's pro rata share from its tax base, was preferable to the House formula, which excluded all tax-exempt interest from investment income, but reduced the deduction for policy and other contract liability requirements by its pro rata share of exempt interest.[12]. Apparently, being unsure of the tax consequences of what they had done, but "to give further assurance that no tax is to be imposed on tax-exempt interest", the Senate then added the exception Sections

[12] After comparing the two treatments, the Committee Report added: "Your committee believes that the division of income and expense items between the policyholders and the insurance company, with only the latter being taken into account for tax purposes, is a much better concept to follow. It also makes it clear that items which are properly exempt * * * such as tax-exempt state and municipal bond interest * * * are properly divided between the policyholders and the life insurance company and that as far as the latter is concerned, namely, the only portion included in the tax base, full allowance is made for these items." 2 USC Cong. & Adm. News, p. 1580.

804(a)(6) and 809(b)(4). 2 USC Cong. & Adm. News, supra, p. 1592.

When the Senate version came to the Floor for consideration the Chairman of the Finance Committee, reporting on the Bill, stated that it was "the intention of the Committee not to impose any tax on tax-exempt interest"; and that the "Treasury has assured the Committee that this formula does not impose any tax on tax-exempt interest. The bill adds a proviso to the effect that if the formula I have described does not result in the imposition of tax on this item, the formula is to be adjusted so that it does not do so." [13]

---

[13] Senator Curtis, who was asked to make the detailed explanation of the statute, made the following statement on the floor of the Senate before the amended version was adopted: "I wish to mention a matter which has deeply concerned your committee. That was the problem of making sure that we did not, by inadvertence, tax any of a life insurance company's tax-exempt interest income. The bill meets this problem most accurately and fairly." He concluded his discussion of the treatment of tax-exempt interest with the following example: "Under the bill, $70 of the $100 tax-exempt interest income would be allocated to policyholders' reserve, and the other $30 would be allocated to the company. Since no part of the policyholders' reserves would become a part of the tax base, no part of the $70 tax-exempt interest allocated to those reserves would be taxed. Moreover, no part of the $30 allocated to the company would be taxed, because a deduction of the full $30 would be made in determining what part of the company's share of its investment income was to be subject to tax.

"Thus, no tax-exempt income or credits of life insurance companies will be included in the tax base of such companies, under this bill. This should allay any fear that any constitutional provision is transgressed." 105 Cong. Record, Part 6, p. 8429. Representative Mills, after the conference committee reached agreement on the final Act, reported to the House: "It is my belief that the appropriate deduction was allowed by the House bill and that these provisions of the final bill, which closely follow the Senate amendments, make no change of sub-

105 Cong. Record, Part 6, p. 8401. A letter from the Treasury, read to the Senate, stated that "It has been the objective of the provisions in question to exclude fully from tax in the hands of life insurance companies the interest on State and municipal bonds. At the same time, however, it has been considered essential not to allow anything in the nature of a double deduction or tax loophole arising from the special characteristics of the unique formula to be applied to these companies." The letter again reviewed the statutory formula for determining an insurance company's taxable income and, referring to the exception sections, expressed the view that "this additional language is not necessary, since we cannot envision a situation in which the operation of the proposed tax formula would result in the substantive imposition of tax on municipal bond interest or on any other form of tax-exempt income." 105 Cong. Record, Part 6, p. 8402. What the Treasury meant by a "substantive imposition" of tax on exempt interest is a matter of doubt and speculation. But, considered in the context of the views expressed before the Committee, and the position taken here, it seems fair to assume that the Treasury recognized that though the inclusion of tax-exempt interest in the formula resulted in an increase of the taxpayer's burden, it was nevertheless within the taxing power of the Congress and would not therefore result in an impermissible imposition, and we consequently have no need to employ the exception provisions of the statute.

Whatever may be said of the extent of the Congressional power to indirectly burden exempt interest in

---

stance." 105 Cong. Record, Part 8, p. 10412. He further stated that the final Act "* * * clarified the language of the House bill to make it definite that we do not intend to tax the interest on tax-exempt securities." Id., 10414.

the exercise of its power to classify all income for purposes of taxation; and whatever may be said of the government's conception of the Congressional intent and purpose to observe those precepts in the enactment of this legislation, it seems manifestly plain to us that Congress did not intend to invade the integrity of the intergovernmental tax immunity doctrine as exemplied in the decisional law when the legislation was under consideration. The prenatal history of this Act convinces us that Congress legislated with an ear to the problem of the marketability of state and municipal securities, and with an eye to the constitutional limitations of National Life on the Congressional power to increase the tax burden of a life insurance company, solely by reason of the receipt of interest from state or municipal securities.

The question then is whether this is a National Life-Gehner case. The trial court did not think so, and, basing its decision on Slayton, concluded that there was in fact no imposition of a prohibited tax. We conclude that our case is within the ambit of the National Life case, which is "radically different" from Slayton. In National Life, the Court invalidated Section 245(a) of the 1921 Act because it in effect increased the taxpayer's tax liability, solely by reason of the receipt of tax-exempt interest. In Slayton, the same Court upheld Section 214(a) of the same Act as a valid measure to prevent the avoidance of tax on taxable income by the simple expedient of borrowing to purchase tax-exempt securities. As the Court observed in Slayton, the taxpayer "was not in effect required to pay more upon his taxable receipts than was demanded of others who enjoyed like incomes solely because he was the recipient of interest from tax-free securities—a result which we found would have followed enforcement of the literal provisions of Section 245(a)." Denman v. Slayton, supra, 519.

And see Helvering v. Independent Life Insurance Co., 292 U.S. 371, 381.

While the extent of the burden on the exempt interest and the form and method of imposing it in our case may differ from National Life, the taxable effect differs only in degree. In both instances the liability of the taxpayer is increased, solely by reason of the receipt of tax-exempt interest, and no form or method for determining it can disguise its incidence. We conclude that the application of the definitions in the Act does result in the imposition of a tax on exempt interest, and the taxpayer is therefore entitled to an adjustment to the extent necessary to prevent such imposition.

It is incumbent upon the taxpayer to prove the amount of the adjustment. It says that it is $11,252.19, and arrives at this amount by simply eliminating exempt interest wherever it is operative in the computation under the statutory formula. While the Government does not quarrel with the taxpayer's arithmetic, it strenuously denies support or sanction of the formula by which it is computed. In that respect it says that the treatment of the tax-exempt interest is the same as if the money used to purchase tax-exempt securities had remained idle.

Be that as it may, the Congress has expressly provided for an adjustment to the extent necessary to prevent the imposition of tax on the exempt interest. And, since we hold that the application of the statutory definitions does in fact result in a prohibited imposition; and since the taxpayer's computations are based upon the elimination of that interest, we must conclude that the adjustment does no more than prevent the prohibited imposition.

Insofar as the judgment of the trial court denies refund of $11,252.19, it is reversed with directions to enter judgment accordingly.

BREITENSTEIN, *Circuit Judge* (concurring in result).

I find it unnecessary to go into the details of the mathematical formulas provided by §§ 804 and 809 of the Life Insurance Company Income Tax Act of 1959, 26 U.S.C. §§ 801–820, or to explore the legislative history of that Act.

Income of the companies subject to the Act is divided into a policyholders' share and a company's share. The company is taxed on its share. The uncontroverted showing of Atlas is that, on the facts pertaining to its 1958 income, the inclusion of interest on tax-exempt securities in the statutory formulas increases the company's share and results in a tax of $11,252.19 more than would have been payable if tax-exempt income had been excluded therefrom. The imposition of tax in this amount results solely from the inclusion in the formulas of income from tax-exempt securities.

Both § 804(a)(6), relating to taxable investment income, and § 809(b)(4), relating to gain from operations, provide that if the application of the definitions found in those sections results in the imposition of a tax on interest which under § 103 is excluded from gross income (interest on state, municipal, and certain other securities), "adjustment shall be made to the extent necessary to prevent such imposition."

The operation of the formulas is such that the tax actually is imposed on taxable income, but this result does not excuse the United States for failing to make the adjustment. National Life Insurance Company v. United States, 277 U.S. 508, and Missouri ex rel. Missouri Insurance Company v. Gehner, 281 U.S. 313, hold that a tax is imposed on tax-exempt property by an increase in tax on taxable property arising solely from the ownership of tax-exempt property.

I grant the power of Congress to classify income, within constitutional limits, for income tax purposes;

and I recognize that the reserve deduction which comes from the division of income into the noted shares is a matter of congressional grace or bounty. The issue is the exercise of a power rather than the existence of a power. The statute under consideration discloses a clear intent not to tax income from state and municipal securities. No uncertainty in this regard exists to require recourse to legislative history for the ascertainment of congressional intent.

We are bound by the National Life and Missouri v. Gehner decisions. With full knowledge of those decisions, Congress provided that if the application of the statutory method causes a tax on tax-exempt income an adjustment shall be made to prevent such a result. By refusing to make the necessary adjustment the government, in effect, has written §§ 804(a)(6) and 809(b)(4) out of the statute. Atlas is entitled to recover the overpayment.

JUDGMENT

First Day, May Term, Monday, May 25th, 1964

Before Honorable ALFRED P. MURRAH, *Chief Judge*, and Honorable JEAN S. BREITENSTEIN and Honorable DELMAS C. HILL, *Circuit Judges*

This cause came on to be heard on the transcript of the record from the United States District Court for the Northern District of Oklahoma and was argued by counsel.

On consideration whereof, it is ordered and adjudged by this court that insofar as the judgment of the trial court denies refund of $11,252.19, it is reversed with directions to enter judgment accordingly.

APPENDIX B

Internal Revenue Code of 1954, as amended by Sec. 2, Life Insurance Company Income Tax Act of 1959, 73 Stat. 112, 26 U.S.C. 1958 ed., Supp. V.

SEC. 103. INTEREST ON CERTAIN GOVERNMENTAL OBLIGATIONS.

(a) *General Rule.*—Gross income does not include interest on—

(1) the obligations of a State, a Territory, or a possession of the United States, or any political subdivision of any of the foregoing, or of the District of Columbia;

* * * * *

SEC. 801. DEFINITION OF LIFE INSURANCE COMPANY.

* * * * *

(b) *Life insurance reserves defined.*

(1) *In general.*

For purposes of this part, the term "life insurance reserves" means amounts—

(A) which are computed or estimated on the basis of recognized mortality or morbidity tables and assumed rates of interest, and

(B) which are set aside to mature or liquidate, either by payment or reinsurance, future unaccrued claims arising from life insurance, annuity, and noncancellable health and accident insurance contracts (including life insurance or annuity contracts combined with noncancellable health and accident insurance) involving, at the time with respect to which the reserve is computed, life, health, or accident contingencies.

(2) *Reserves must be required by law.*

* * * * *

in addition to the requirements set forth in paragraph (1), life insurance reserves must be required by law.

* * * * *

SEC. 802. TAX IMPOSED.

(a) *Tax Imposed.*—

(1) *In general.*—A tax is hereby imposed for each taxable year beginning after December 31, 1957, on the life insurance company taxable income of every life insurance company. Such tax shall consist of—

(A) a normal tax on such income computed at the rate provided by section 11(b), and

(B) a surtax, on so much of such income as exceeds $25,000, computed at the rate provided by section 11(c).

* * * * *

(b) *Life Insurance Company Taxable Income Defined.*—For purposes of this part, the term "life insurance company taxable income" means the sum of—

(1) the taxable investment income (as defined in section 804) or, if smaller, the gain from operations (as defined in section 809),

(2) if the gain from operations exceeds the taxable investment income, an amount equal to 50 percent of such excess, plus

(3) the amount substracted from the policyholders' surplus account for the taxable year, as determined under section 815.

* * * * *

SEC. 804. TAXABLE INVESTMENT INCOME.

(a) *In general.*—

(1) *Exclusion of policyholders' share of investment yield.*—The policyholders' share of each and every item of investment yield (including tax-exempt in-

terest, partially tax-exempt interest, and dividends received) of any life insurance company shall not be included in taxable investment income. For purposes of the preceding sentence, the policyholders' share of any item shall be that percentage obtained by dividing the policy and other contract liability requirements by the investment yield; except that if the policy and other contract liability requirements exceed the investment yield, then the policyholders' share of any item shall be 100 percent.

(2) *Taxable investment income defined.*—For purposes of this part, the taxable investment income for any taxable year shall be an amount (not less than zero) equal to the sum of the life insurance company's share of each and every item of investment yield (including tax-exempt interest, partially tax-exempt interest, and dividends received), reduced by—

(A) the sum of—

(i) the life insurance company's share of interest which under section 103 is excluded from gross income,

(ii) the deduction for partially tax-exempt interest provided by section 242 (as modified by paragraph (3)) computed with respect to the life insurance company's share of such interest, and

(iii) the deductions for dividends received provided by sections 243, 244, and 245 (as modified by paragraph (5)) computed with respect to the life insurance company's share of the dividends received; and

(B) the small business deduction provided by paragraph (4).

For purposes of the preceding sentence, the life insurance company's share of any item shall be that percentage which, when added to the percentage obtained under the second sentence of paragraph (1), equal 100 percent.

* * * * *

(6) *Exception.*—If it is established in any case that the application of the definition of taxable investment income contained in paragraph (2) results in the imposition of tax on—

(A) any interest which under section 103 is excluded from gross income,

(B) any amount of interest which under section 242 (as modified by paragraph (3)) is allowable as a deduction, or

(C) any amount of dividends received which under sections 243, 244, and 245 (as modified by paragraph (5)) is allowable as a deduction,

adjustment shall be made to the extent necessary to prevent such imposition.

(b) *Gross Investment Income.*—For purposes of this part, the term "gross investment income" means the sum of the following:

(1) *Interest, etc.*—The gross amount of income from—

(A) interest, dividends, rents, and royalties,

* * * * *

(c) *Investment Yield Defined.*—For purposes of this part, the term "investment yield" means the gross investment income less the following deductions—

(1) *Investment expenses.*—Investment expenses for the taxable year. * * *

* * * * *

SEC. 805. POLICY AND OTHER CONTRACT LIABILITY REQUIREMENTS.

(a) *In General.*—For purposes of this part, the term "policy and other contract liability requirements" means, for any taxable year, the sum of—

(1) the adjusted life insurance reserves, multiplied by the adjusted reserves rate,

(2) the mean of the pension plan reserves at the beginning and end of the taxable year, multiplied by the current earnings rate, and

(3) the interest paid.

(b) *Adjusted Reserves Rate and Earnings Rates.*—

(1) *Adjusted reserves rate.*—For purposes of this part, the adjusted reserves rate for any taxable year is the average earnings rate or, if lower, the current earnings rate.

(2) *Current earnings rate.*—For purposes of this part, the current earnings rate for any taxable year is the amount determined by dividing—

(A) the taxpayer's investment yield for such taxable year, by

(B) the mean of the taxpayer's assets at the beginning and end of the taxable year.

(3) *Average earnings rate.*—

(A) *In general.*—For purposes of this part, the average earnings rate for any taxable year is the average of the current earnings rates for such taxable year and for each of the 4 taxable years immediately preceding such taxable year (excluding any of such 4 taxable years for which the taxpayer was not an insurance company).

* * * * *

(4) *Assets.*—For purposes of this part, the term "assets" means all assets of the company (including nonadmitted assets), other than real and personal property (excluding money) used by it in carrying on an insurance trade or business. * * *

* * * * *

(c) *Adjusted Life Insurance Reserves.*—

(1) *Adjusted life insurance reserves defined.*—For purposes of this part, the term "adjusted life insurance reserves" means—

(A) the mean of the life insurance reserves (as defined in section 801(b)), other than pension plan reserves, at the beginning and end of the taxable year, multiplied by

(B) that percentage which equals 100 percent—

(i) increased by that percentage which is 10 times the average rate of interest assumed by the taxpayer in calculating such reserves, and

(ii) reduced by that percentage which is 10 times the adjusted reserves rates.

(2) *Average interest rate assumed.*—For purposes of this part, the average rate of interest assumed in calculating reserves shall be computed—

(A) by multiplying each assumed rate of interest by the means of the amounts of such reserves computed at that rate at the beginning and end of the taxable year, and

(B) by dividing (i) the sum of the products ascertained under subparagraph (A), by (ii) the mean of the total of such reserves at the beginning and end of the taxable year.

* * * * *

SEC. 809. IN GENERAL.

(a) *Exclusion of Share of Investment Yield Set Aside for Policyholders.*—

(1) *Amount.*—The share of each and every item of investment yield (including tax-exempt interest, partially tax-exempt interest, and dividends received) of any life insurance company set aside for policyholders shall not be included in gain or loss from operations. For purposes of the preceding sentence, the share of any item set aside for policyholders shall be that percentage obtained by dividing the required interest by the investment yield; except that if the required interest exceeds the investment yield, then the share of any items set aside for policy holders shall be 100 percent.

(2) *Required interest.*—For purposes of this part, the required interest for any taxable year is the sum of the products obtained by multiplying—

(A) each rate of interest required, or assumed by the taxpayer, in calculating the reserves described in section 810(c), by

(B) the means of the amount of such reserves computed at that rate at the beginning and end of the taxable year.

(b) *Gain and Loss From Operations.*—

(1) *Gain from operations defined.*—For purposes of this part, the term "gain from operations" means the amount by which the sum of the following exceeds the deductions provided by subsection (d);

(A) the life insurance company's share of each and every item of investment yield (including tax-exempt interest, partially tax-exempt interest, and dividends received); and

(B) the sum of the items referred to in subsection (c).

* * * * *

(3) *Life insurance company's share.*—For purposes of this subpart, the life insurance company's share of any item shall be that percentage which, when added to the percentage obtained under the second sentence of subsection (a)(1), equals 100 percent.

(4) *Exception.*—If it is established in any case that the application of the definition of gain from operations contained in paragraph (1) results in the imposition of tax on—

(A) any interest which under section 103 is excluded from gross income,

(B) any amount of interest which under section 242 (as modified by section 804(a)(3)) is allowable as a deduction, or

(C) any amount of dividends received which under sections 243, 244, and 245 (as modified by subsection (d)(8)(B) is allowable as a deduction,

adjustment shall be made to the extent necessary to prevent such imposition.

* * * * *

(d) *Deductions.*—For purposes of subsections (b)(1) and (2), there shall be allowed the following deductions:

* * * * *

(8) *Tax-exempt interest, dividends, etc.*—

(A) *Life insurance company's share.*—Each of the following items:

(i) the life insurance company's share of interest which under section 103 is excluded from gross income,

(ii) the deduction for partially tax-exempt interest provided by section 242 (as modified by section 804(a)(3)) computed with respect to the life insurance company's share of such interest, and

(iii) the deductions for dividends received provided by sections 243, 244, and 245 (as modified by subparagraph (B)) computed with respect to the life insurance company's share of the dividends received.

* * * * *

U.S. GOVERNMENT PRINTING OFFICE: 1954

LIBRARY
SUPREME COURT, U. S.

Office-Supreme Court, U.S.
FILED
OCT 12 1964
JOHN F. DAVIS, CLERK

IN THE

Supreme Court of the United States

OCTOBER TERM, 1964

No. 489

UNITED STATES OF AMERICA,
Petitioner,

v.

ATLAS LIFE INSURANCE COMPANY,
Respondent.

BRIEF IN OPPOSITION TO PETITION FOR WRIT OF CERTIORARI

NORRIS DARRELL
Attorney for Respondent
48 Wall Street
New York, New York 10005

M. BERNARD AIDINOFF
KENDYL K. MONROE
SULLIVAN & CROMWELL

DICKSON M. SAUNDERS
DOERNER, STUART, MORELAND
& SAUNDERS

BYRON V. BOONE,
BOONE & ELLISON

THOMAS C. THOMPSON, JR.
BIRD AND THOMPSON
Of Counsel.

INDEX

	PAGE
Question Presented	1
Statement	2
Argument	6
Conclusion	16

CITATIONS

CASES:

Commissioner v. *Shamberg's Estate*, 144 F. 2d 998 (2d Cir. 1944), *cert. denied*, 323 U. S. 792 (1945) ---- 15

Crowell v. *Benson*, 285 U. S. 22 (1932) ---- 14

Denman v. *Slayton*, 282 U. S. 514 (1931) ---- 11

Eisner v. *Macomber*, 252 U. S. 189 (1920) ---- 13

Helvering v. *Griffiths*, 318 U. S. 371 (1943) ---- 13

Helvering v. *Independent Life Ins. Co.*, 242 U. S. 371 (1934) ---- 11

Missouri ex rel. *Missouri Ins. Co.* v. *Gehner*, 281 U. S. 313 (1930) ---- 8, 12, 13, 15

National Life Ins. Co. v. *United States*, 277 U. S. 508 (1928) ---- 2, 8, 9, 11, 12, 13, 15

Tobin v. *United States*, 306 F.2d 270, *cert. denied*, 371 U. S. 902 (1962) ---- 15

STATUTES:

Internal Revenue Code of 1954

Section 801-820 ---- 4

Section 804(a)(1) ---- 4

PAGE

Section 804(a)(6) ---------- 3, 5, 7, 10, 11, 12, 15
Section 809(a)(1) ---------- 4
Section 809(b)(4) ---------- 3, 5, 7, 10, 11, 12, 15

Pub. L. 88-571, 78 Stat. 857 (1964) ---------- 12

Revenue Act of 1921, ch. 136, 42 Stat. 261
Section 245(a)(1) ---------- 2
Section 245(a)(2) ---------- 2

MISCELLANEOUS:

105 Cong. Rec. (1959) ---------- 9, 10

Hearings Before the Senate Finance Committee on H. R. 4245, 86th Cong., 1st Sess. (1959) -- 9

Hearings Before the Senate Finance Committee on H. R. 5739, 88th Cong., 2d Sess. (1964) --- 12

H. R. 4245, 86th Cong., 1st Sess. (1959) ---------- 3

S. Rep. No. 291, 86th Cong., 1st Sess. (1959) --- 4, 9

IN THE

Supreme Court of the United States

OCTOBER TERM, 1964

No. 489

UNITED STATES OF AMERICA,
Petitioner,

v.

ATLAS LIFE INSURANCE COMPANY,
Respondent.

BRIEF IN OPPOSITION TO PETITION FOR WRIT OF CERTIORARI

This brief is submitted in opposition to the Petition for a Writ of Certiorari to the United States Court of Appeals for the Tenth Circuit in the above-entitled case.[1]

Question Presented

This case does not involve a constitutional question, hypothetical or otherwise. The sole question is one of statutory interpretation:

Is a tax imposed on state and municipal bond interest contrary to the intent of Congress in enacting the Life Insurance Company Income Tax Act of 1959 when a larger share of the investment income of a life insurance company is taxed to it and its income tax liability is increased solely by reason of the receipt of such interest?

[1] The petition is referred to herein as "Pet."; the appendix thereto as "App."; and the Transcript of Record in the Court of Appeals as "R."

Statement

Throughout most of the history of the Federal income taxation of life insurance companies, each year's taxable investment income has been reduced by an allowance determined with reference to liabilities under insurance contracts out of recognition that annual increases in such liabilities are a cost of doing business as a life insurance company.

The Revenue Act of 1921 provided a deduction from investment income equal to the amount by which 4 per cent of the mean of the life insurance company's reserve funds required by law exceeded the company's tax-exempt interest. Ch. 136, § 245(a)(2), 42 Stat. 261. Interest on state and municipal bonds was also deductible in full. Section 245(a)(1). In *National Life Ins. Co.* v. *United States*, 277 U. S. 508 (1928), it was held that the reduction of the 4 per cent deduction by the amount of tax-exempt interest received could not be given effect because it would result in the taxation of such interest contrary to the Constitution of the United States and the Congressional policy not to tax such interest reflected elsewhere in the statute. Thereafter, under the 1921 Act and subsequent revenue acts applicable to all years up to 1958, the deduction in respect of reserve liability increases was not affected by the individual company's receipt of tax-exempt interest.[2]

[2] Until 1941, the deduction continued to be determined by multiplying the company's reserves by a given rate enacted into the statute. From 1942 to 1957, the deduction was expressed as a percentage of the company's net investment income; the percentage was computed under one formula or another for the entire life insurance industry and did not change because of an individual company's receipt of state or municipal bond interest.

In 1958 the House initially passed a bill in which the deduction for increases in policyholder liabilities was continued in the computation of both "taxable investment income" and "gain from operations". However, this deduction was reduced by an allocated portion of state and municipal bond interest. H.R. 4245, 86th Cong., 1st Sess., §§ 804(a), 805(e), 809(d)(2), 809(f)(1) (1959). The Senate changed the deduction to an exclusion for the "policyholders' share" of each and every item of investment income, including a pro rata portion of such interest, which resulted in taxing the same amount of investment income to the company as the "company's share" as resulted from the deduction provided in the House bill. This change in the designation of the allowance was of no legal significance, since the company alone was liable for any taxes on the income from its investments.[3] At the same time, the Senate adopted the provisions, each entitled "Exception", now found in Sections 804(a)(6) and 809(b)(4) of the Internal Revenue Code of 1954 which direct that adjustments shall be made if in any case e application of the definitions of "taxable invest- t income" and "gain from operations" results in nposition of tax on state and municipal bond or certain other items.

[3] Life insurance companies alone are the owners of their assets and the earnings thereon. Their reserves are liabilities, and annual increases in reserve liabilities are calculated on the basis of actuarial tables and assumed interest rates without reference to earnings on any investments made by the company. For Federal income tax purposes, such earnings are taxable only to the company, and only the company is concerned with whether they are fully taxable or partially or wholly tax-exempt. The taxation of trusts and their beneficiaries to which petitioner refers (Pet. 18 n.9, 19) is not analogous, since life insurance companies are not conduits.

The bill as amended by the Senate was finally enacted as the Life Insurance Company Income Tax Act of 1959, Pub. L. 86-69, 73 Stat. 112, 26 U. S. C. §§ 801-820, which is applicable to taxable years beginning after December 31, 1957.

The "policyholders' share" as defined under the Act includes a percentage of each and every item of investment income.[4] Petitioner concedes that, under this approach, if additional state and municipal bond interest is received, a larger share of the taxable items of investment income will normally be taxed to the company than if such interest had not been received.[5] (Pet. 7-8, 12-13 & n.5.) The effect on the company's tax liability is the same as if the "policyholders' share" exclusion were simply a deduction from investment income and the deduction were reduced by a pro rata

[4] The "policyholders' share" is equal in amount to the amount designated "policy and other contract liability requirements" in the computation of "taxable investment income" and "required interest" in the computation of "gain from operations". Sections 804(a)(1) and 809(a)(1). It was estimated by the Senate Finance Committee that $460 million of the $500 million of revenue expected to be derived for 1958 under the bill as amended by the Committee would be attributable to "taxable investment income". S. Rep. No. 291, 86th Cong., 1st Sess. 12 (1959).

[5] In the computation of "taxable investment income", the amount of respondent's "policy and other contract liability requirements" did not remain constant because tax-exempt interest was included in the earning rates which were applied to "adjusted life insurance reserves" to arrive at the amount. This increased "policy and other liability requirements", but the increase was not proportionate to the amount of tax-exempt interest, and there was, therefore, a net increase in the amount of investment income taxed to respondent after excluding the policyholders' share. See App. 6a-7a & n.8; 333 F. 2d at 392-93 & n.8. This will not always be the case, however, as petitioner recognizes. (Pet. 13 n.5.) In the computation of "gain from operations", respondent's "required interest" was not affected by the receipt of tax-exempt interest.

share of tax-exempt interest, although it probably was not fully understood that the "policyholders' share" exclusion would have this effect when it was first proposed.

Petitioner also concedes that respondent's tax liability for 1958 computed without adjustment was increased by $11,252.19 solely because of its receipt of $36,637.79 of state and municipal bond interest, and that its tax liability would be further increased if it received additional interest of this type. (Pet. 9-10, 12, 17.) At the trial it was shown that respondent's tax liability would be increased at a marginal or effective rate of 29.1% by reason of the receipt of additional interest on state and municipal bonds, and that if such interest were subject to a tax burden at that marginal rate, a fully taxable corporate bond would be more likely under normal market conditions to be a better investment for respondent than a state or municipal bond of the same quality. (R. 44-46.)

The Court of Appeals held that the increase in the Federal income tax liability of respondent which resulted solely from its receipt of interest from state and municipal bonds was not intended by Congress, and that the adjustments expressly provided in Sections 804(a)(6) and 809(b)(4) were intended to eliminate the increase. (App. 19a, 20a; 333 F.2d at 398, 399.)

The adjustments determined by the Court of Appeals were computed by removing interest on state and municipal bonds at every point where the receipt of such interest might affect the determination of re-

spondent's tax. (App. 20a; 333 F.2d at 399.) Thus the computation of the "policyholders' share", and ultimately the amount of the taxable items of investment income on which respondent's tax was based, was made neutral with respect to the receipt of interest on state and municipal bonds. The adjustment did not have the effect claimed by petitioner (Pet. 2, 10, 15) of "allocating" all tax-exempt interest to the company and only items of taxable income to the policyholders' share exclusion.[6] Just like any other deduction, the "policyholders' share" was neither decreased nor increased because of the receipt of such interest, and the company's ultimate tax liability was not affected by the receipt of such interest.

Argument

I.

The "policyholders' share" concept, stated by petitioner to be the "cornerstone" of a "carefully formulated statutory plan" (Pet. 11, 12), was not adopted or even proposed in the process of enacting the Life Insurance Company Income Tax Act of 1959 until after hearings had been held by the Senate Finance

[6] In the computation of "taxable investment income", in addition to removing state and municipal bond interest from "investment yield" for the purpose of determining the percentage of investment income to be excluded as the "policyholders' share", such interest was omitted from the earnings rates used to determine "policy and other contract liability requirements". If earnings rates had not been so adjusted, the reduction in the amount of investment income taxed to respondent would have been even greater. State and municipal bonds were not excluded from assets in determining the earnings rates, being treated, in effect, like idle bank accounts, since the exclusion of such bonds from assets (just as the inclusion of interest thereon in earnings) would have increased earnings rates to respondent's benefit, thereby increasing the amount to be refunded to respondent.

Committee on a bill not containing such provisions which had been drafted and recommended by the Treasury Department and had been approved by the House of Representatives. At the same time that the "policyholders' share" concept was added to the bill, the adjustment provisions of Sections 804(a)(6) and 809(b)(4) were also adopted. The Court of Appeals correctly viewed this case as involving only a determination of the extent to which Congress intended to legislate. (App. 9a; 333 F.2d at 393.) A brief review of the legislative history of these provisions, which the Court of Appeals relied on[7] but which is not referred to in the petition, confirms that the Court of Appeals correctly followed the intent of Congress in applying the adjustment provisions.

The deduction and "add back" provisions in the bill initially passed by the House were severely criticized in the hearings before the Senate Finance Committee by both testifying witnesses and Committee members on two grounds:

> 1. Since the amount of the deduction and hence the ultimate tax liability would vary with the receipt of state and municipal bond interest, the tax burden thereby imposed on the receipt of such interest would increase the cost of borrowing by state and municipal governments. Throughout the Senate Finance Committee hearings, concern over this effect of the House bill was repeatedly expressed by state and local government officials and by members of the Committee.[8] The continu-

[7] One Court of Appeals Judge, concurring in the result, found it unnecessary to explore the legislative history since the statute discloses a clear intent not to tax income from state and municipal securities. App. 21a-22a; 333 F.2d at 399-400.

[8] See, *e.g.*, the references at App. 15a n.11; 333 F.2d at 396 n.11.

ing concern of state and municipal governments with the economic burden in the form of higher interest rates that would be imposed on such entities is evidenced by the participation of representatives of 11 nationwide associations of state and municipal officials in an *amicus* brief in the Court of Appeals which supported respondent's position.[9]

2. The House bill was repeatedly condemned in the Senate Finance Committee hearings on the ground that the reduction of the reserve deduction because of the receipt of state and municipal bond interest was inconsistent with the principle of intergovernmental tax immunity set forth in *National Life Ins. Co.* v. *United States,* 277 U. S. 508 (1928), and *Missouri* ex rel. *Missouri Ins. Co.* v. *Gehner,* 281 U. S. 313 (1930). Although the reduction in the reserve deduction under the House bill was not identical in amount with the reduction under the statute in *National Life,* it could not be reconciled with the constitutional doctrine applied in that case, and it was substantially identical with the pro rata reduction which was struck down in *Gehner* on the same grounds. The relevance of these cases and their constitutional importance was unmistakably brought to

[9] The brief in the Court of Appeals was submitted on behalf of the Governors' Conference; The National Association of Attorneys General; The American Municipal Association; The United States Conference of Mayors; The National Association of Counties; The National Institute of Municipal Law Officers; The Council of State Governments; The National Association of State Auditors, Comptrollers and Treasurers; The National Association of County Civil Attorneys; The Municipal Finance Officers Association and the Conference on State Defense. The attorneys for the respective organizations who signed the brief included persons holding the office of Governor; Attorney General, Mayor, City Attorney, County Counsel and State Comptroller.

the attention of the Senate Finance Committee.[10] While representatives of the Treasury Department suggested at one point that the continuing validity of the constitutional aspects of *National Life* might be questioned,[11] this view was strongly disputed in statements by both testifying witnesses and a member of the Committee.[12]

Neither of the objections made before the Senate Finance Committee to the treatment of tax-exempt interest under the House bill was remedied by changing the deduction and "add-back" provisions of the House bill to an "exclusion" which had the effect of subtracting the same amount from total investment income before arriving at the net amount of investment income on which the company's tax was based. While the division of income and expenses into a "policyholders' share" and a "company's share" was recommended as a "better concept" by the Senate Finance Committee at the suggestion of the Treasury Department, this was, as Senator Byrd said, "a most complicated bill",[13] and there remained doubts as to the effect this change would have. To resolve those doubts, the adjustment provisions were added to the bill at the same time and the Senate Finance Committee report stated that this "makes it clear that in no case is any tax to be imposed on tax-exempt interest. . . ." S. Rep. No. 291, 86th Cong., 1st Sess. 18 (1959). The adjustment provisions,

---

[10] See, *e.g.*, the references at App. 14a-15a n.10; 333 F.2d at 396 n.10.

[11] *Hearings Before the Senate Finance Committee on H.R. 4245*, 86th Cong., 1st Sess. 50-51 (1959). Petitioner makes a similar suggestion at Pet. 20.

[12] See, *e.g.*, *Hearings*, *supra* note 11, pp. 309, 318, 701.

[13] 105 Cong. Rec. 8400 (1959).

which are equally applicable to the intercorporate dividends received deduction, obviously served a more substantive purpose than is recognized by petitioner's assertion (Pet. 14-15) that Congress was only concerned with providing a means for precluding an ultimate challenge to the constitutional immunity of state and municipal bond interest from Federal taxation, for the dividends received deduction is not embroiled in such constitutional issues. In the subsequent legislative debates leading to enactment of the bill, it was repeatedly stated without qualification that, under the bill as amended by the Senate Finance Committee, no tax would be imposed on tax-exempt interest and there would be no denial of the full intercorporate dividends received deduction. The adjustment provisions were referred to in most of these statements. *E.g.*, 105 Cong. Rec. 8401, 10400, 10413-14. Although petitioner has readily conceded in its brief in the Court of Appeals and in the petition herein that the tax computed without the adjustments is increased solely by reason of the receipt of state and municipal bond interest, this result was not pointed out by those who spoke for the government at the time the bill was before Congress—most likely because they too did not completely understand at the time the operation of the complex formulae.

Without the adjustments in respondent's tax liability under Sections 804(a)(6) and 809(b)(4), the division of income and expenses between a "policyholders' share" and a "company's share" on an item-by-item basis has the same effect, when applied to state and municipal bond interest, as if a deduction for an ordinary business expense or any other deduction were denied

taxpayers to the extent of a pro rata portion of tax-exempt interest received in the same year. *Cf.* Pet. 19, 21. This would be a novel concept in our tax laws, which have never denied a deduction for expenses or other deductible items not related to the receipt of tax-exempt income. The Court of Appeals rightly concluded that, whatever might be said in favor of the method of taxation described by petitioner, Congress ultimately did not intend to legislate inconsistently with the principle recognized in *National Life*, and it enacted the adjustment clauses to make sure that the tax burden of a life insurance company would not be increased solely by reason of the receipt of interest from state or municipal securities.[14] (App. 19a; 333 F.2d at 398.) Congress did not intend that the "attribution of expense" approach advocated by petitioner (Pet. 18-20, 21), which was the approach of the House bill and was continued as the "policyholders' share" exclusion in the bill finally enacted, should be tested in litigation under the Life Insurance Company Income Tax Act of 1959.

The decision of the Court of Appeals applying the adjustments provided in Sections 804(a)(6) and 809(b)(4) is, therefore, fully in accord with the legislative history. The decision was also brought to the attention of Congress in the hearings cited by peti-

[14] The Court of Appeals also noted that in *Denman* v. *Slayton*, 282 U. S. 514 (1931), to which petitioner refers in support of its position (Pet. 19), it was stated, in an opinion written by the same Justice who wrote the opinion for the Court in *National Life*, that the tax burden imposed on taxable items of income in *National Life* was "radically different" from the denial of deductions for expenses incurred in earning tax-exempt income, which was involved in *Denman* v. *Slayton*. (App. 11a, 19a; 333 F.2d at 395, 398-99.) See also *Helvering* v. *Independent Life Ins. Co.*, 242 U. S. 371, 381 (1934).

tioner as the source for its claims as to the "staggering amounts" of revenue that turn on the decision (Pet. 16). Although it was pointed out that the litigation arose under the provisions of Sections 804(a)(6) and 809(b)(4), and although the bill before Congress related to amendments to the Life Insurance Company Income Tax Act of 1959, Congress took no remedial action. In fact, despite the claimed annual revenue loss of $77,000,000 (Pet. 16),[15] Congress passed the bill and adjourned without even acting with respect to the current year. See Pub. L. 88-571, 78 Stat. 857 (1964).

II.

Petitioner states (Pet. 20) that the only substantial question posed by this case is the scope to be given to the decisions in *National Life Ins. Co.* v. *United States*, 277 U. S. 508 (1928), and *Missouri* ex rel. *Missouri Ins. Co.* v. *Gehner*, 281 U. S. 313 (1930). In effect, petitioner means to limit or to question the continuing validity of the intergovernmental tax immunity doctrine enunciated in those decisions, which it admits (Pet. 20) supports the decision of the Court of Appeals. The Court of Appeals did not reach the question posed by petitioner since, after reviewing the legislative history, it concluded: "[I]t seems mani-

---

[15] The current annual reduction estimated by the Treasury Department was $75 million. *Hearings Before the Senate Finance Committee on H. R. 5739*, 88th Cong., 2d Sess. 29 (1964).

In any event, the reciprocal of the alleged "revenue loss" by the Federal government from the unimpaired exemption of state and local bond interest is that state and local governments are spared the equivalent burden in the form of higher interest rates, which is what Congress intended by the adjustment clauses.

festly plain . . . that Congress did not intend to invade the integrity of the intergovernmental tax immunity doctrine as exemplified in the decisional law when the legislation was under consideration." App. 19a; 333 F. 2d at 398.

In *Helvering* v. *Griffiths*, 318 U. S. 371 (1943), it was held in comparable circumstances that the constitutional validity of the decision in *Eisner* v. *Macomber*, 252 U. S. 189 (1920), could not be reconsidered. The statute in that case provided that a stock dividend was not taxable to the extent that it did not constitute income within the Sixteenth Amendment to the Constitution. The Court, in an opinion by Mr. Justice Jackson, stressed that it could not reconsider a prior constitutional decision in a tax case until it first found that the statute imposed a tax contrary to that decision, and it held that the statute before it could not be so interpreted in light of the legislative history showing that Congress had no intention of imposing a tax on stock dividends inconsistent with *Eisner* v. *Macomber*.

In this case, the Court of Appeals correctly invoked the adjustment clauses to eliminate the conceded conflict with the principle of *National Life* and *Gehner* that would otherwise result contrary to the intent of Congress. Just as in *Helvering* v. *Griffiths*, there is no statutory basis for reaching the constitutional question posed by petitioner.

Petitioner explains the adjustment clauses as "providing statutory authority for a judicial 'remodeling' of the statute should it be held 'unconstitutional' as written." (Pet. 15 n.6.) This almost imputes to Con-

gress an intent to abdicate its legislative responsibility and to delegate it to the judiciary. Furthermore, such an interpretation, if it were conceivable, would require the Court, if it granted certiorari, to examine the constitutional framework of the statute without the adjustment clauses, and thus to delve into the delicate area of intergovernmental tax immunities. Plainly, by enacting the adjustment clauses, Congress intended to avoid this type of constitutional litigation with respect to the Life Insurance Company Income Tax Act of 1959. Denying review in this case would not prevent Congress from changing its mind and provoking such constitutional litigation, but unless and until it does, review of the question which petitioner seeks to have reviewed is not warranted.

Only if the phrase "imposition of tax" in the adjustment clauses were construed in a legalistic, semantic fashion, rather than in the economic sense which Congress undoubtedly had in mind, would it become necessary to consider any constitutional question. In *Crowell* v. *Benson*, 285 U. S. 22, 62 (1932), Chief Justice Hughes said: "Where the validity of an act of the Congress is drawn in question, and even if a serious doubt of constitutionality is raised, it is a cardinal principle that this Court will first ascertain whether a construction of the statute is fairly possible by which the question may be avoided." It is only a strained construction of the statute such as that advanced by petitioner that even approaches a constitutional question in this case. The Court of Appeals, applying the adjustment clauses in accordance with their plain meaning, avoided any constitutional issue. When it declined to ignore the adjustment clauses, it acted to preserve, not

to "nullify" or "invalidate", the "statutory plan", as petitioner suggests. (Pet. 12, 13.) Since this interpretation was in accordance with the expressed intent of Congress, there is no reason for this Court to consider the constitutional question posed by petitioner.

The denial of certiorari in this case would be consistent with the Court's long standing policy of avoiding decisions on constitutional issues where such decisions are not necessary to the disposition of the case or to provide a workable interpretation of the statute. Such action would be particularly appropriate where, as here, the avoidable constitutional controversy is in the sensitive area of state and federal governmental relationships (see, *e.g.*, 323 U. S. 792 (1945), denying certiorari in *Commissioner* v. *Shamberg's Estate*, 144 F.2d 998 (2d Cir. 1944); and 371 U. S. 902 (1962), denying certiorari in *Tobin* v. *United States*, 306 F.2d 270 (1962)), and especially where, as here, the legislative history not only indicates that Congress had no desire to invite such controversy, but in fact demonstrates an affirmative desire to avoid it.

Since the legislative history makes it clear that the *National Life* and *Gehner* decisions were to be followed, as was done by the Court of Appeals, in determining the economic burden which the adjustments provided in Sections 804(a)(6) and 809(b)(4) were intended to avoid, and since it is the policy of this Court to avoid where possible sensitive constitutional questions such as that which petitioner seeks to inject into this case, the only issue posed by petitioner cannot appropriately be reached and there remains no issue in this case of sufficient importance to justify the granting of the petition for certiorari.

CONCLUSION

For the foregoing reasons, it is respectfully submitted that the petition for a writ of certiorari should be denied.

Respectfully submitted,

NORRIS DARRELL
Attorney for Respondent
48 Wall Street
New York, New York 10005

M. BERNARD AIDINOFF
KENDYL K. MONROE
SULLIVAN & CROMWELL
48 Wall Street
New York, New York 10005

DICKSON M. SAUNDERS
DOERNER, STUART, MORELAND
& SAUNDERS
1218 Atlas Life Building
Tulsa, Oklahoma 74111

BYRON V. BOONE
BOONE & ELLISON
914 World Building
Tulsa, Oklahoma 74111

THOMAS C. THOMPSON, JR.
BIRD AND THOMPSON
1000 Connecticut Avenue, N.W.
Washington, D. C. 20206
Of Counsel.

LIBRARY
SUPREME COURT, U. S.

Supreme Court, U.S.
FILED
FEB 13 1965
JOHN F. DAVIS, CLERK

No. 469

In the Supreme Court of the United States

October Term, 1964

UNITED STATES OF AMERICA, PETITIONER

v.

ATLAS LIFE INSURANCE COMPANY

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT

BRIEF FOR THE UNITED STATES

ARCHIBALD COX,
Solicitor General,
LOUIS F. OBERDORFER,
Assistant Attorney General,
WALTER G. SCHARLAU,
PHILIP R. MONAHAN,
Assistants to the Solicitor General,
Department of Justice,
Washington, D.C., 20530.

INDEX

	Page
Opinions below	1
Jurisdiction	1
Question presented	2
Statute involved	2
Statement	4
1. Life insurance reserves	5
2. The statute	9
3. Facts and proceedings below	11
Summary of argument	15
Argument:	
Introduction	20
I. The statutory formula does not violate the assumed constitutional prohibition against a tax on interest from State bonds	20
A. In taxing net income Congress may limit the deduction allowed against gross income from taxable sources to the fairly apportioned share of an item chargeable against gross income from both taxable and non-taxable sources	30
B. The 1959 Act makes a fair apportionment of the annual addition to the reserve for shareholders	32
1. Treating the policyholders' reserve as a deduction for deferred costs, it is fair and reasonable to limit the deduction to that part of the costs allocable to the production of taxable income	45
2. The special interests of the policyholders in the reserve furnish additional justification for the apportionment	

763-293—65——1

Argument—Continued
II. Since the statutory apportionment does not violate the assumed constitutional prohibition against a tax on State-bond interest, the "exception clauses" are inoperative ..... Page 52
A. The interrelationship between the several parts of the statute shows that the function of the exception clause is to provide an adjustment only if the statutory formula violates the assumed constitutional prohibition against a tax on interest from State bonds 55
B. The legislative history shows that the function of the exception clause is to provide an adjustment only if the statutory formula violates the assumed constitutional prohibition against a tax on interest from State bonds 62
Conclusion 77
Appendix A 79
Appendix B 84
Appendix C 87

CITATIONS

Cases:
Alabama v. *King & Boozer*, 314 U.S. 1 19
Burnet v. *Wells*, 289 U.S. 670 ..... 49, 50
Butler Bros. v. *McColgan*, 315 U.S. 501 ..... 14, 28, 43
Corliss v. *Bowers*, 281 U.S. 376 49
Cream of Wheat Co. v. *County of Grand Forks*, 253 U.S. 325 43
Denman v. *Slayton*, 282 U.S. 514 ..... 13, 26, 36, 39, 40, 42, 62
Eisner v. *Macomber*, 252 U.S. 189 ..... 60, 61
Flint v. *Stone Tracy Co.*, 220 U.S. 107 27
Ford Motor Co. v. *Beauchamp*, 308 U.S. 331 43
Graves v. *New York*, 306 U.S. 466 19
Greiner v. *Lewellyn*, 258 U.S. 384 ..... 14, 28
Helvering v. *Griffiths*, 318 U.S. 371 ..... 60, 61, 62
Helvering v. *Independent Life Ins. Co.*, 292 U.S. 371 ..... 13, 14, 25, 41, 42, 44, 45, 62
International Harvester Co. v. *Evatt*, 329 U.S. 416 44
James v. *Dravo Contracting Co.*, 302 U.S. 134 19
Lustman v. *Commissioner*, 322 F. 2d 253 25
Maxwell v. *Bugbee*, 250 U.S. 525 43

Cases—Continued Page

McCulloch v. *Maryland*, 4 Wheat. 316 38
McLeod v. *Dilworth Co.*, 322 U.S. 327 28
Missouri Ins. Co. v. *Gehner*, 281 U.S. 313 ..... 10, 38, 40, 42, 59, 65, 75
National Life Insurance Co. v. *United States*, 277 U.S. 508 ..... 10, 17, 37, 38, 40, 42, 59, 62, 65, 75, 76
New Jersey Realty Title Ins. Co. v. *Division of Tax Appeals*, 338 U.S. 665 39
New York v. *United States*, 326 U.S. 572 38
New York Life Ins. Co. v. *Bowers*, 39 F. 2d 557, affirmed, 283 U.S. 242 48
Northwest Cement Co. v. *Minnesota*, 358 U.S. 450 ..... 28, 43
Pacific Co. v. *Johnson*, 285 U.S. 480 ..... 14, 27
Penn Mutual Co. v. *Lederer*, 252 U.S. 523 48
Reinecke v. *Smith*, 289 U.S. 172 50
Underwood Typewriter Co. v. *Chamberlain*, 254 U.S. 113 ..... 28, 43
United States v. *City of Detroit*, 355 U.S. 466 19
United States Glue Co. v. *Town of Oak Creek*, 247 U.S. 321 ..... 28, 43
Western Union Telegraph Co. v. *Kansas*, 216 U.S. 1 43
Willcuts v. *Bunn*, 282 U.S. 216 28

Statutes:

Internal Revenue Act of 1936, 53 Stat. 47 ..... 60, 61
Internal Revenue Code of 1954, as amended by Sec. 2 of the Life Insurance Company Income Tax Act of 1959, 75 Stat. 112, 26 U.S.C. 1958 ed., Supp. V:
Sec. 103 87
Sec. 162 24
Sec. 167 24
Sec. 243 73
Sec. 262 ..... 12, 24, 36
Sec. 265(1) 35
Sec. 265(2) 40
Sec. 401 46
Sec. 501(a) 46
Sec. 501(c) 46
Sec. 662 13
Sec. 662(a) 27
Sec. 662(b) 27

Statutes—Continued — Page

Secs. 801–820 — 2
Sec. 801(b) — 87, 88
Sec. 802(a) — 88
Sec. 802(b) — 2, 4, 88
Sec. 804(a) — 3, 14, 52, 89, 90
Sec. 804(b) — 90
Sec. 804(c) — 42, 90, 91
Sec. 805 — 7, 91
Sec. 805(b) — 91
Sec. 805(c) — 7, 92
Sec. 809(a) — 2, 5, 93
Sec. 809(b) — 3, 9, 14, 52, 93, 94
Sec. 809(d) — 94, 95
Revenue Act of 1916, 39 Stat. 756 — 28
Revenue Act of 1918, 40 Stat. 1070 — 28
Revenue Act of 1921, 42 Stat. 227 — 17, 28, 37, 41, 42
Revenue Act of 1924, 43 Stat. 253 — 28
Revenue Act of 1942, 56 Stat. 870 — 17, 18, 53, 63
73 Stat. 622 — 39
31 U.S.C. 742 — 39

Miscellaneous:
105 Cong. Rec. 8401 — 66, 70
105 Cong. Rec. 8402 — 54, 74
105 Cong. Rec. 8429 — 68
105 Cong. Rec. 10400 — 66, 69
105 Cong. Rec. 10412 — 70
Gray, *Derivative Tax Immunity and the Income From State Bonds*, 41 Col. L. Rev. 1357 — 19
H.R. 4245, 86th Cong., 1st Sess — 53, 63
Hearings on H.R. 4245 before the Senate Finance Committee, 86th Cong., 1st Sess — 64, 65, 66, 67, 73, 75
H. Rep. No. 2333, 77th Cong., 2d Sess — 17, 63
H. Rep. No. 34, 86th Cong., 1st Sess — 63
Huebner & Black, *Life Insurance* — 48
Institute of Life Insurance, *Life Insurance Fact Book* (1959) — 48
S. Rep. No. 1631, 77th Cong., 2d Sess — 17, 63
S. Rep. No. 291, 86th Cong., 1st Sess — 68, 69
Taxation of Government Bondholders and Employees, U.S. Department of Justice (G.P.O., 1939) — 19
Wurzel, *Tax-Exempt Interest of Life Insurance Companies*, 70 Yale L.J. 15 — 48

In the Supreme Court of the United States

OCTOBER TERM, 1964

No. 489

UNITED STATES OF AMERICA, PETITIONER

v.

ATLAS LIFE INSURANCE COMPANY

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT

BRIEF FOR THE UNITED STATES

OPINIONS BELOW

The opinion of the district court (R. 15–22) is reported at 216 F. Supp. 457. The opinion of the court of appeals (R. 95–116) is reported at 333 F. 2d 389.

JURISDICTION

The judgment of the court of appeals was entered on May 25, 1964 (R. 116). By order of Mr. Justice White, dated August 22, 1964, the time for filing a petition for a writ of certiorari was extended to and including September 11, 1964 (R. 117). The petition was filed on that date and was granted on December 7, 1964 (R. 118). The jurisdiction of this Court rests on 28 U.S.C. 1254(1).

QUESTION PRESENTED

A life insurance company derives its total investment income partly from non-taxable State and municipal bonds and partly from other, taxable sources. It is required annually to add to a reserve for policyholders a specific sum constituting the greater portion of its total investment income. In taxing the net taxable income of life insurance companies Congress prescribed a statutory formula which has the effect (1) of apportioning the annual addition to the reserve to non-taxable and taxable income *pro rata* and (2) of limiting the deduction allowed against taxable income to its proportionate part of the addition to the reserve. However, having in mind the constitutional intergovernmental tax immunities, Congress also provided that the tax should be adjusted if the formula resulted in the imposition of a tax "on" income from State and municipal bonds.

The question presented is whether the formula results in a tax "on" State and municipal bonds.

STATUTE INVOLVED

The relevant portions of the Internal Revenue Code of 1954, as amended by the Life Insurance Company Income Tax Act of 1959, are set forth in Appendix C, *infra*, pp. 87–95.

STATEMENT

Under the Life Insurance Company Income Tax Act of 1959 (§§ 801–820 of the Internal Revenue Code of 1954, as amended), the taxable income of a life insurance company includes the full amount of its "gain from operations" up to the amount of its "taxable investment income," plus one-half of any additional "gain from operations" (§ 802(b)). "Taxable in-

vestment income" and "gain from operations" are defined in detail in §§ 804(a) and 809(b), respectively, but each of those provisions contains an "exception" providing that, if the application of the definition "results in the imposition of tax on" State and municipal bond interest, "adjustment shall be made to the extent necessary to prevent such imposition" (§§ 804(a)(6), 809(b)(4)).

In its income tax return for 1958, respondent computed its income in accordance with the statutory definitions of "taxable investment income" and "gain from operations." In due course, however, it brought this suit for refund contending that the application of the statutory definitions resulted in the imposition of tax on its municipal bond interest. The court of appeals, reversing the district court, held that the statute does impose a tax on municipal bond interest and, to eliminate that effect, adjusted respondent's tax under the "exception" clauses.

A fuller statement of the issue and of the reasoning of the court below requires an explanation of the nature of life insurance reserves and of the statutory plan for the taxation of life insurance companies. Since the statutory definitions of "taxable investment income" and of "gain from operations" present the same issue but require somewhat different computations, we will for simplicity hereafter confine the discussion, except as otherwise expressly noted, to the definition of "gain from operations," the definition that requires the simpler and more easily understood computations.[1]

[1] The selection of "gain from operations" for the major exposition can also be justified on the ground that, if anything, it is the measure that has the greater impact on the company's

1. *Life insurance reserves.*—The premiums charged for life insurance are calculated on the assumption that the premiums received by the company will be invested and earn interest which, when added to the accumulated premiums, will be sufficient to pay the policyholders' claims as they accrue. The rate of interest assumed in determining premiums is also employed in computing the "reserve" for policyholder claims which State law normally requires the company to maintain. The reserve is computed as that amount which, with an annual growth at the assumed rate of interest, will be sufficient (with the future premiums) to pay the actuarially-predicted policyholder claims. The mortality tables and the assumed rate of interest used in the computations are regulated by State law, and if the net assets of the company fall below the reserve so computed, the company is deemed insolvent and may no longer continue in business.

Since the reserve is computed by "discounting" the predicted policyholder claims to the present at the assumed rate of interest, it is obviously necessary, if the reserve is to continue to measure the company's ability to meet its policyholder obligations, that the reserve be increased each year by an amount equal to the interest that it was assumed the assets

---

final taxable income. Changes in "gain from operations" will always affect taxable income by at least 50% of the amount of the change, and sometimes (when it is less than "taxable investment income") by 100%. Changes in "taxable investment income," on the other hand, never affect taxable income by more than 50% of their amount, and sometimes (when it exceeds "gain from operations") not at all. See § 802(b).

represented by the reserve would earn. Thus, out of the income actually earned each year from the investment of the premium receipts, a certain portion—that part representing the assumed rate of interest—must be "set aside" and added to the reserve to "fund" the anticipated policyholder obligations.

2. *The statute.*—The basic problem which the Act of 1959 sought to resolve is—how to define and treat the additions to the reserve for tax purposes. The basic principle adopted by Congress is clear. Congress continued to follow, albeit in a new form, the longstanding policy of not taxing the portion of a life insurance company's income that is required to be set aside as an addition to the reserve. In computing "gain from operations" under the statutory definition, the total "investment yield" (investment income less investment expenses) is divided between the "policyholders' share" and the "company's share." The amount allocated to the policyholders is equal to the assumed interest rate times the reserves (the "required interest," § 809(a)(2)) and thus represents the amount required to be added to the reserves to fund the predicted policyholder claims. The amount allocated to the company is simply the balance. The "policyholders' share" so determined is wholly excluded from the company's income and only the "company's share" enters into its "gain from operations." In short, the company is taxed only on the excess of the investment income over the amount required to be added to the reserves.

So much is clear. The difficulty arises from the fact that since total investment income is, of course,

composed of many different kinds of income (dividends, royalties, rents, taxable interest, tax-exempt interest, *etc.*), it is further necessary to say of what kinds of income the "policyholders' share" and the "company's share" are to be deemed composed. The statute solves that problem by allocating each item of income pro rata between the two shares. Thus, if the required addition to the reserve is $800,000 and the investment yield for the year is $1,000,000, 80% of each item of income is allocated to the policyholders and excluded from the company's income. The $200,000 allocated to the company is deemed to be composed of the remaining 20% of each item of income and is taxed accordingly, with the appropriate deductions then being allowed for tax-exempt interest, intercorporate dividends, *etc.* If, for example, the $1,000,000 investment yield included $100,000 of tax-exempt interest, the company's $200,000 share of the total investment yield would be deemed to include $20,000 (*i.e.*, 20%) of the tax-exempt interest and the amount subject to federal income tax would accordingly be reduced by that amount, leaving $180,000 to be included in "gain from operations." The other $80,000 of tax-exempt interest is deemed to have been already excluded as a part of the policyholders' $800,000 share of the total income, so that no further exclusion on its account is required.[2]

[2] The method of computing "taxable investment income" is substantially identical except that, in determining the amount of income to be allocated to the policyholders (called the "policy and other contract liability requirements"), the reserves are multiplied, not by the assumed rate of interest (as in computing "gain from operations"), but by the rate of return

The necessary effect of the statutory formula is that the receipt of tax-exempt interest will cause the company's "gain from operations", and hence its tax liability, to be higher than it would have been if that interest had not been received. That may be seen by comparing the example just given ($1,000,000 investment yield including $100,000 of tax-exempt interest, which produces $180,000 of taxable gain from operations) with the result that would be reached if the tax-exempt interest were eliminated, leaving $900,000 of investment yield composed entirely of taxable items. Because the "required interest" is a fixed amount (reserves times assumed interest rate) determined without reference to actual investment yield, the amount allocated to the policyholders would still be the same $800,000 and only $100,000 would be left as the company's share to be included in "gain from operations." Thus the receipt of an additional $100,000 of income in the form of tax-exempt interest causes "gain from operations" to be increased by $80,000.[3]

---

actually realized by the company from the investment of its assets (either during the current year or, if lower, during the past five years) (§ 805). The effect of using the earnings rate rather than the assumed rate is dampened, however, by a further adjustment which reduces the amount so determined by 1% for every tenth of a percentage point by which the earnings rate exceeds the assumed rate; if the earnings rate is less than the assumed rate, the amount is increased by the same ratio (§ 805(c)(1)(B)). The net effect is the same as though the reserves were multiplied by a rate somewhere in between the assumed rate and the earnings rate.

[3] The computation of gain from operations on the assumed facts is illustrated both in tabular form and graphically in Appendix A, *infra*, pp. 79–83.

The explanation of that result is simple. Because the absolute amount of income allocated to the policyholders is a constant (equal to the "required interest"), the *fraction* of the investment yield that must be allocated to them decreases as the investment yield increases. To give the policyholders $800,000 requires 100% of an investment yield of $800,000; 88.9% of a yield of $900,000; and only 80% of a yield of $1,000,000. By increasing the investment yield, therefore, the receipt of tax-exempt interest reduces the fraction of all the other income that must be allocated to the policyholders, thus leaving a larger part of the other income to be included in the company's gain from operations. In short, the reason that the receipt of tax-exempt interest causes an increase in tax is simply that it provides a larger base out of which the fixed claims of the policyholders can be satisfied, thus reducing their claims against the taxable items of income.[4]

Having defined "gain from operations" in a way necessarily causing it to be increased upon the receipt of municipal bond interest—the inevitable result of the pro rata allocation of such interest between the

[4] The described consequences are those of the receipt of *additional* income in the form of tax-exempt interest. Very different is the case of a *substitution of* tax-exempt income for taxable income, which results instead in a decrease in tax fully commensurate with the extent to which the company's taxable income is taxed. With a fully taxable investment yield of $1,000,000 and a policyholder's share of $800,000, only 20% of the investment yield would be included in gain from operations. Commensurately, gain from operations would be reduced by 20% of any part of the investment yield that was shifted from taxable income to tax-exempt income.

"policyholders' share" and the "company's share"—the statute concludes with the "exception" clause on which the decision below was based. That clause (§ 809(b)(4)) provides that:

> If it is established in any case that the application of the definition of gain from operations * * * results in the imposition of tax on [municipal bond interest, *inter alia*] * * *, adjustment shall be made to the extent necessary to prevent such imposition.

3. *Facts and proceedings below.*—During 1958, respondent received interest on municipal bonds in the amount of $36,637. Its total "investment yield," including that interest, was $894,277. The "required interest" on its reserves was $781,540 (R. 100).

In its income tax return for 1958, respondent computed its "gain from operations" in accordance with the statutory definition. A part of the investment yield ($894,277) equal to the required interest on the reserves ($781,540) was excluded as the "policyholders' share," leaving $112,737 as the "company's share." The company's share, being 12.6% of the total investment yield, was treated as including 12.6% of the municipal bond interest, or $4,619. A deduction was taken for that amount, leaving $108,118 as the net investment income to be included in gain from operations.

In its claim for refund and in the proceedings below, respondent claimed that the application of the statutory definition "result[ed] in the imposition of tax on" its municipal bond interest because it resulted in a higher gain from operations (and hence tax) than

there would have been if it had not received the tax-exempt interest. To prevent that result, it contended, its gain from operations should be recomputed under the "exception" clause by eliminating the municipal bond interest from the "investment yield" at the outset, reducing the investment yield to $857,640. The same amount would then be excluded as the "policyholders' share" ($781,540), leaving only $76,100 as the net investment income to be included in gain from operations. The resulting $32,018 reduction in gain from operations is exactly equal, it may be seen, to the portion of the municipal bond interest (87.4%) which the statutory formula allocated to the policyholders. The essential difference in the computations is that the statutory formula treats the amount allocated to the policyholders as consisting of a pro rata part of every item of income, including municipal bond interest, while respondent's computation allocates to the policyholders only taxable items of income and allocates all of the municipal bond interest to the company.[5]

The district court held that respondent was not being taxed on its municipal bond interest under the statutory definitions and denied the refund. The court of appeals reversed. It construed this Court's decisions in *National Life Insurance Co.* v. *United States,* 277 U.S. 508, and *Missouri Insurance Co.* v. *Gehner,* 281 U.S. 313, as meaning that a tax is unconstitutionally imposed "on" tax-exempt interest

[5] Respondent's method of computation is illustrated in tabular form and compared with the method prescribed by the Act in Appendix A, Schedule A, pp. 80–83, *infra*.

whenever "the liability of the taxpayer is increased, solely by reason of the receipt of tax-exempt interest" (R. 114). By that standard, a tax was being imposed "on" respondent's municipal bond interest, since its tax was greater than it would have been if that interest had not been received. Since the court considered itself bound by the *National Life* and *Gehner* decisions as to what constitutes a tax "on" tax-exempt interest, and since any challenge to the constitutional immunity of municipal bond interest from taxation was foreclosed by the "exception" clauses of the statute, the court held that respondent was entitled to adjust its tax, under the "exception" clauses, to what it would have been if the municipal bond interest had not been received. Specifically, the court approved respondent's reduction of its "gain from operations" from $108,118 (the result under the statutory definitions) to $76,100 (the result under respondent's method of computation described above).

SUMMARY OF ARGUMENT

For over forty years Congress has allowed life insurance companies a deduction or exclusion for the annual "interest" addition to the policyholders' reserve which is necessary to pay future claims. Whether the addition to the reserve has been deducted from gross income on the ground that it is the cost of using premium receipts to earn both taxable and tax-exempt investment income for the company or has been excluded from gross income on the ground that it represents a part of the investment income which is never beneficially enjoyed by the company, Con-

gress has also recognized, for over forty years, the need of an accommodation between the reserve exemption and the exemption for interest from State bonds. The accommodation adopted in the 1959 Act is in principle identical to that used, without challenge, since 1942. The addition to the reserve is considered attributable, on a pro-rata basis, to the company's taxable and tax-exempt investment income.

1. In enacting the accommodation found in the 1959 Act, Congress fully respected the traditional constitutional immunity of interest from State bonds. There is simply no way of determining which items of *gross* income a *net* income tax is "on" without first determining what deductions are properly attributable to each item of gross income and what items of gross income are attributable to the taxpayer. Congress has made this determination fairly in the 1959 Act and then has allowed a full exemption for tax-exempt interest.

a. If the exemption is treated as a deduction for the principal cost of producing both taxable and tax-exempt investment income for the company (as the respondent contends it should be), the deduction can and should be reduced to the extent that it is properly attributable to the production of tax-exempt income. This is all that the 1959 Act has done. Congress does not generally allow deductions against taxable income if, or to the extent, an expense is not the cost of producing taxable income. One application of this general rule is the denial of a deduction for personal expenses (§ 262); another is that Congress need not permit deductions against taxable income for the costs of producing tax-exempt income. This is the precise

holding of *Denman* v. *Slayton*, 282 U.S. 514, and *Helvering* v. *Independent Life Ins. Co.*, 292 U.S. 371, and controls the present case.

b. If the reserve exemption is considered an exclusion of that part of the investment income which the company holds in trust for the policyholders and does not itself beneficially enjoy—and, in view of the function and State regulation of the reserve, Congress could so consider it—the excluded share should be treated, like ordinary trust income (see § 662), as made up of pro-rata portions of each class of gross income. The company should be allowed to deduct only that part of the total tax-exempt interest which has not already been excluded as beneficially the property of the policyholders. No other method of determining the taxable and tax-exempt content of the shares of total investment income going to the company and the policyholders' reserve has any claim to fairness or rationality.

c. The apportionment of a single item of expense pro rata between the types of income it helps to produce and the denial of a deduction for that part of the expense attributable to producing tax-exempt income necessarily means that the expense deduction will be reduced when the taxpayer receives additional tax-exempt income. Similarly, the allocation of a pro-rata part of tax-exempt income to satisfy the fixed and prior claims of one beneficiary (here the reserve for policyholders) necessarily means that the other beneficiary (here the company) will have more taxable income left when there is more tax-exempt income. In both cases, the result is an increase in net taxable in-

come when there is an increase in tax-exempt income. But this fact alone has never been held to establish that a tax is imposed on tax-exempt income. See, *e.g.*, *Helvering* v. *Independent Life Ins. Co.*, 292 U.S. 371; *Butler Bros.* v. *McColgan*, 315 U.S. 501; *cf. Pacific Co.* v. *Johnson*, 285 U.S. 480; *Greiner* v. *Lewellyn*, 258 U.S. 384.

2. Because the statutory formula is consistent with the traditional constitutional immunity from taxation of interest from State bonds, the "exception" clauses (§§ 804(a)(6) and 809(b)(4)) are inapplicable. By their terms, the clauses apply to require a judicial adjustment of the statutory formula only if a tax had been imposed "on" interest from State bonds. Both the interrelationship of the various sections of the 1959 Act and its legislative history demonstrate that the determination whether a tax was imposed on interest from State bonds is to be made by reference to the only context where these terms have previously been used, the traditional constitutional immunity, and not to some unspecified but allegedly more stringent Congressional standard enacted simultaneously with the statutory taxing formula.

Obviously Congress did not first enact a detailed taxing formula and then ask the courts to determine whether it was consistent with some other Congressional policy enacted in general terms as an "exception" in the same Act; Congress decides for itself the consistency of two of its own policies. In particular, Congress could not have intended to require, by the "exception" clauses, a judicial modification of the statute whenever the receipt of tax-exempt interest

increased the company's tax, for that was the plain, necessary, and intended effect of the statutory formula. Nor did Congress intend the same self-contradictory result by incorporating the broadest implications of those decisions of this Court relied upon by the opponents of the Act, without regard to subsequent decisions which further rationalized and developed the scope of the immunity; the "exception" clauses refer to the whole immunity doctrine, not to particular decisions by name. In short, Congress meant the courts to measure its statute against an external standard as to which they were more expert than Congress—the traditional constitutional immunity. This conclusion is fully confirmed by the legislative history which shows that the function of the "exception" clauses was to reassure those who were anxious to maintain the established immunity of State bonds and to prevent a defense of the statute which would cast that immunity in doubt.

ARGUMENT

Introduction

Because State law requires life insurance companies to add an "interest" or "income" item each year to the reserve fund they must hold to meet policyholders' future claims, the federal income tax has, for over forty years, afforded life insurance companies the unique tax advantage of not paying tax on most of the investment income they receive, *i.e.*, on the income which must be added to the reserve fund under State law. The company's income out of which is made the required addition to the reserve

for policyholders (or, alternatively viewed, the income earned at the cost of the annual addition to the reserve fund) generally includes interest from bonds of States or their subdivisions (hereafter "State bonds"), a type of income always exempted from the federal income tax. For over forty years Congress has attempted to accommodate the deduction for additions to the policyholders' reserve to the exemption for interest from State bonds so as to reflect the fact that part of the addition to the reserve is attributable to tax-exempt income. The question in the present case concerns the accommodation enacted in the Life Insurance Company Income Tax Act of 1959.

There are three basic approaches to the problem. To illustrate, assume that a life insurance company, which has $100 of net investment income ($90 in taxable income and $10 in tax-exempt interest), is required to add $80 to its reserve for policyholders. Pattern A assumes that all the tax-exempt dollars are added to the reserve along with $70 of taxable items. The result is that after the addition to the reserve the company is left with $20 of taxable income. Pattern B assumes that no tax-exempt dollars are added to the reserve, which is given $80 in taxable items. From the remaining $20 attributed to the company, the 10 tax-exempt dollars would then be subtracted, leaving a taxable income of only $10. The third approach, Pattern C, would treat the company and the reserve for policyholders as each receiving a pro-rata share of the taxable and tax-exempt dollars. The reserve, which receives 80 per-

cent of the total income would receive 80 percent of the taxable dollars ($72) and 80 percent of the tax-exempt income ($8). The company would be taxed only on 20 percent of the taxable income, or $18.

In the Revenue Act of 1921 Congress adopted the first approach (Pattern A) and attributed all the tax-exempt income to the reserve for policyholders. 42 Stat. 227, 261. That treatment was held unconstitutional in *National Life Insurance Co.* v. *United States,* 277 U.S. 508, as imposing a tax on interest from State bonds. After a lapse of some years during which the statute was not amended, Congress passed the Revenue Act of 1942 adopting what we have called Pattern C, a pro rata allocation of taxable and tax-exempt dollars to both the policyholders' reserve and the company. The allocation was accomplished on an industry-wide formula so that a particular company's reserve deduction was reduced by an increase in industry holdings of tax-exempt bonds, but not by an increase in its own holdings of these bonds. 56 Stat. 870. The reason for the 1942 amendments was clearly explained: "under existing law life insurance companies are in effect allowed to deduct part of their tax-exempt interest twice. * * * Part of the earnings on the reserve is derived from tax-exempt interest; yet the whole allowance for reserve earnings is deducted from taxable investment income." H. Rep. No. 2333, 77th Cong., 2d Sess., pp. 107–108; see also S. Rep. No. 1631, 77th Cong.,

2d Sess., p. 142. The Revenue Act of 1942 eliminated most of the double allowance Neither the 1942 formula nor similar successors was ever attacked as imposing a tax on State bonds despite their use in the period 1942–1957.

In the Life Insurance Company Income Tax Act of 1959 Congress continued the pro-rata allocation of part of the tax-exempt interest to the policyholders' reserve, but specified that this allocation should be applied to each individual company rather than on an industry-wide basis. The sole question presented in this case is whether the application of Pattern C to individual insurance companies under the 1959 Act imposes a tax on interest from State bonds.

The question whether a federal tax is on income from State bonds has meaning only in the context of actual or supposed intergovernmental immunities. If the 1959 Act did not contain the exception clauses, a challenge to its constitutionality would present two questions: (1) whether the Act imposes a tax on interest from State bonds; and (2) whether, if it does, Congress has the power to tax such interest. The latter issue, it is important to note, would be a very substantial question, for the decisions of this Court sustaining the power of Congress to tax income from renting property, selling goods, or furnishing services to a State have created serious doubts about the continuing vitality of the earlier d sions denying the power of Congress to tax income from lending money

to a State.[6] That question, however, was pretermitted by the exception clauses, and we take it as a predicate that no tax may be constitutionally laid on income from State bonds. We show in Point I that the 1959 Act does not impose a tax on the income from State bonds such as would offend the assumed constitutional prohibition. In Point II we show that the exception clauses do no more than prohibit a tax on State bonds in the constitutional sense.

---

[6] In the past thirty years and subsequent to this Court's last decisions holding the income from State bonds constitutionally immune from federal taxation, the Court has undertaken a major reconsideration of the scope of intergovernmental immunities. During this period it has held that a private party can be taxed by the United States on his salary from a State (*Graves* v. *New York*, 306 U.S. 466) and can be taxed by a State on his gross receipts as an independent contractor from furnishing services to the United States (*James* v. *Dravo Contracting Co.*, 302 U.S. 134), on his gross receipts from sale or rental of property to the United States (*Alabama* v. *King & Boozer*, 314 U.S. 1), and even on the value of the use of federally owned property (*United States* v. *City of Detroit*, 355 U.S. 466). The anomaly, in light of these decisions, of continuing to deny the federal government the power to tax a private party's receipts from lending money to a State has been made the subject of a major study by the Department of Justice (*Taxation of Government Bondholders and Employees*, Government Printing Office, 1939) and has been emphasized by leading authorities (see, *e.g.*, Gray, *Derivative Tax Immunity and the Income From State Bonds*, 41 Col. L. Rev. 1357). The immunity has also been attacked by Presidents of every political persuasion from Harding and Coolidge to Hoover and Roosevelt (see Department of Justice Study, *supra*, at pp. 201–202).

I

THE STATUTORY FORMULA DOES NOT VIOLATE THE ASSUMED CONSTITUTIONAL PROHIBITION AGAINST A TAX ON INTEREST FROM STATE BONDS

A. IN TAXING NET INCOME CONGRESS MAY LIMIT THE DEDUCTION ALLOWED AGAINST GROSS INCOME FROM TAXABLE SOURCES TO THE FAIRLY APPORTIONED SHARE OF AN ITEM CHARGEABLE AGAINST GROSS INCOME FROM BOTH TAXABLE AND NON-TAXABLE SOURCES

Under the Act—under Pattern C—the annual addition to the policyholders' reserve is treated as composed in part of any tax-exempt dollars of income from State bonds and in part of taxable dollars from other sources. Since the company must add a fixed amount to the policyholders' reserve, the result of treating the addition as composed in any part of tax-exempt items is that a company with only taxable income will have to add more of this income to the reserve and will retain less taxable income for itself than it would if it had tax-exempt income in addition, part of which would be used to make the necessary addition to the reserve. Under Pattern C, therefore, the receipt of an increment of tax-exempt income, all others things being equal, will necessarily increase the amount of taxable income the company has after additions to the reserve, and will thus increase its total tax.[7] That much is undisputed. The only question

[7] As shown in the Statement, that will always be so under the definition of "gain from operations." The same result will *normally* occur also under the definition of "taxable investment income", but whether it will *necessarily* occur depends upon what assumptions are made in computing what the taxable investment income "would have been" without the tax-exempt interest. "Taxable investment income" computed under the statu-

is whether this necessary result of a pro rata allocation of taxable and tax-exempt income between the policyholders' reserve and the company results in the imposition of a tax *on* interest from State bonds within the meaning of the assumed constitutional prohibition.

To determine whether a net income tax is a tax on a particular item of gross income (here, interest from State bonds), respondent and the court below offer a simple rule of arithmetic: if the tax is greater than it would have been if the taxpayer had not received the given item in addition to his other income, then the increase is a tax on that item. Since the definitions of

---

tory definition will always be greater than it would have been if the company had not had the municipal bonds. It will usually, but not necessarily always, be greater than it would have been if the company had had the bonds but had not received the interest, which is the assumption respondent and the court of appeals employed in recomputing respondent's taxable investment income. Leaving the bonds in the company's assets but removing the interest from the investment yield causes a marked reduction in the earnings rate (investment yield divided by assets) and thus in the amount of income allocated to the policyholders (reserves times earnings rate, see note 2, *supra*). The reduced exclusion for the policyholders' share tends to offset the reduction in the investment yield, and in extreme circumstances can fully offset it. The justification for using wholly disparate factors in computing the earnings rate (dividing both taxable and exempt assets into the income from the taxable assets alone) is not apparent, however. Nor is it apparent why respondent and the court below are willing to tolerate the inclusion of tax-exempt bonds in the asset account when the effect is to increase taxable investment income. By the court of appeals' standard, that results in imposing a tax "on" the bonds themselves which, if anything, is surely more objectionable than imposing a tax merely on the interest from the bonds.

"gain from operations" and "taxable investment income" in the 1959 Act admittedly cause the tax liability of a life insurance company which receives interest from State bonds to be greater than it would have been if the company had not received the interest and all other items remained constant, they conclude that the Act imposes a tax on interest from State bonds. If we were dealing with a simple tax upon gross income received by a taxpayer exclusively for his own benefit without deductible costs, then it might be true to say that a tax liability which is increased because of the addition of an increment of State bond interest is, to some extent, a tax on the income from the bonds. But that is not this case; here we deal with net income after sundry subtractions from the received income coming into the company's possession.

The simplistic analysis is demonstrably irrelevant in dealing with a tax on the net income remaining to a taxpayer after offsetting against the total gross income coming into his possession allowances for income not fairly taxable to him, for costs, etc. True, one can still perform the arithmetical computation which shows that the exclusion of the increment of State-bond interest would result, all other items constant, in a lower tax, but the arithmetic is meaningless unless one also considers whether the State-bond interest has such a relation to other items entering into the determination of taxable net income that the receipt or non-receipt of the State bond justifies a change in the corresponding elements of the arithmetical computation. In other words, in judging the alleged impact of a tax upon net income upon one of

several items of gross income one cannot ignore the problems of apportioning any offsetting items as well as the tax, and the propriety of a particular apportionment cannot be determined merely by arithmetic.

The point is easily demonstrated by example. Suppose that a taxpayer has expenses of $80 and gross income of $100 consisting of four different items of income of $25 each (Items 1–4). If the taxpayer were required to pay a tax on his net income of $20, which item of gross income would the tax be imposed "on"? Arithmetic alone cannot answer the question. It is meaningless to say that the entire tax is imposed on Item 1 because without it there would have been no tax, for the same thing could be said with equal validity of each of the other items with the result that the entire tax would be found to be imposed on each. If arithmetic alone is to provide the answer, the only possible solution is to say that, since each item was equally indispensable in producing the result, they should be treated as contributing equally to the net income—*i.e.*, the $20 of net income should be deemed to consist of $5 of each of the four items of gross income and each would be to that extent the subject of the tax.

A more reasoned judgment could be made only by examining the offsetting expenses and determining how they should be allocated against the several items of income. Suppose, for example, that Expense A ($40) was a fixed expense that cannot be said to have contributed any more to the production of one item of income than another; that Expense B ($20) contributed equally to the production of Items 1 and 2

but not at all to the production of Items 3 and 4; and that Expenses C ($5), D ($8), and E ($7) were specifically incurred in producing, respectively, Items 2, 3, and 4. On that analysis of the character of the expenses, it would plainly be reasonable to charge Item 1 with $20 of expenses (¼ of A plus ½ of B); Item 2 with $25 (same, plus C); Item 3 with $18 (¼ of A plus D); and Item 4 with $17 (¼ of A plus E). With the expenses so allocated, the $20 of net income—the subject of the tax—could then fairly be said to consist of $5 of Item 1, none of Item 2, $7 of Item 3, and $8 of Item 4. And if, say, Item 3 happened to be constitutionally immune from tax, the constitution would require no more, we submit, than that the net income be reduced by $7, leaving $13 subject to tax.[8]

The problem of allocation is in no way unique to the treatment of interest from State bonds. If a taxpayer uses an automobile solely for business purposes, he can deduct, *inter alia*, the full amount of the depreciation for the year (§§ 162, 167). If he uses the automobile solely for personal purposes, he is entitled to no deductions (§ 262). If he uses the automobile partly for business and partly for personal purposes, to what extent can the depreciation be deducted? Since the annual depreciation recognized for tax purposes is generally unaffected by the extent of actual use, it could be said that the personal use, not having increased the depreciation, should be disregarded and the entire depreciation should be treated

[8] A similar example is set out in tabular form in Appendix B (Ex. 1), pp. 84–85, *infra*.

as a business cost. With equal logic, however, it could be said that it is the business use, which likewise did not increase the depreciation, which should be disregarded and that the entire depreciation should be treated as a personal expense. The solution reached under present law is, of course, neither: the depreciation is allocated in the proportion in which the taxpayer actually used the automobile for the two purposes, with only 60 percent of the depreciation being deductible if it is found that only 60 percent of the taxpayer's use of the automobile was for business purposes.[9] On the face of it, such an allocation is eminently reasonable and presents no constitutional problem. Yet under respondent's but-for reasoning the partial disallowance of an otherwise deductible cost because the taxpayer also used the automobile for personal purposes results in imposing a tax "on" his personal use of the automobile, a tax that would at least arguably be unconstitutional as an unapportioned "direct" tax (cf. *Helvering* v. *Independent Life Ins. Co.*, 292 U.S. 371). The fallacy, of course, lies in the calculus that would convert a disallowance of the deduction to the extent that the expense is reasonably attributable to the taxpayer's personal use of the automobile into an imposition of tax "on" that personal use itself.

The principle is equally applicable to the allocation of expenses partly attributable to the cost of realizing tax-exempt interest. Suppose that *A* had a gross in-

[9] See, *e.g.*, *Lustman* v. *Commissioner*, 322 F. 2d 253 (C.A. 3); I.R.S. Form 2106, "Statement of Employee Business Expenses." See Appendix B (Ex. 2), p. 85, *infra*.

come of $25,000, made up of $20,000 in rents from real estate and $5,000 of income from State bonds, both purchased with borrowed funds upon which his interest payments are $20,000 annually. Properly determined, *A's* taxable net income is $4,000. The constitution does not require apportioning to the rental income ($20,000) more than its fair four-fifths share ($16,000) of *A's* total costs ($20,000). *Denman* v. *Slayton,* 282 U.S. 514. Yet here again respondent's simplistic formula would erroneously tell us that there was a tax on the State bond interest, for *A's* tax will be higher than if the non-taxable interest had not been received.

Substantially identical problems of allocation are presented in the allocation of income between co-beneficiaries (as distinguished from the allocation of expenses to income). Suppose that a trust instrument requires the trustee to pay *A* $80 a year out of the trust income (or, if necessary, out of principal) and to pay the balance of the income, if any, to *B* and that in the given year the trust has income of $100 consisting of $20 of each of five kinds of income: oil royalties, domestic dividends, foreign tax-paid dividends, interest from State bonds, and interest from corporate bonds. The total income is distributed $80 to *A* and $20 to *B*. For purposes of determining who is entitled to the percentage-depletion deduction, the dividends-received credit, the credit for foreign taxes, and the exclusion for tax-exempt interest, which beneficiary receives which income? The question can be answered only by recourse to a principle of allocation, and the only one with any claim to reason is that adopted by

Congress: *A*, having received 80 percent of the total income, is deemed to have received 80 percent of each item; *B*, having received 20 percent of the total, is deemed to have received 20 percent of each item; and *A* and *B* then account accordingly (§ 662(a)(1) and (b)).

The result, of course, is that *B* is required to pay a tax he would not have had to pay if the interest from State bonds had not been received, in which event *B* would have received nothing. Moreover, if *A* is in a lower tax bracket than *B* or is a tax-exempt entity, the total tax paid by both *A* and *B* will be greater than it would have been without the tax-exempt interest.[10] Yet we are confident that not even respondent, despite its arithmetical formula, will suggest that the trust provisions making that allocation are for that reason unconstitutional.

There is nothing novel in these propositions. The books are full of cases, in addition to *Denman* v. *Slayton, supra,* showing that neither this Court nor Congress has ever believed that every taxing formula which results in an increase in the total tax because of the receipt or ownership of tax-exempt income or property imposes a tax on that income or property. Franchise or privilege taxes can constitutionally be measured by total income, including that from State or federal bonds. See, *e.g., Flint* v. *Stone Tracy Co.,* 220 U.S. 107; *Pacific Co.* v. *Johnson,* 285 U.S. 480;

[10] A similar example of the effects of the statutorily prescribed method of allocating trust income is set out in tabular form in Appendix B (Ex. 3), pp. 85–86, *infra.*

Cf. Corporate Excise Tax, Revenue Act of 1916, § 407, 39 Stat. 789; Revenue Act of 1918, § 1000, 40 Stat. 1126; Revenue Act of 1921, § 1000, 42 Stat. 294 Revenue Act of 1924, § 700, 43 Stat. 325. The federal estate tax can constitutionally be applied to the full value of State bonds (*Greiner* v. *Lewellyn,* 258 U.S. 384) and the income tax can validly be applied to the profits made on resale of such bonds (*Willcuts* v. *Bunn,* 282 U.S. 216). A State may not constitutionally tax sales wholly unconnected with the State (*McLeod* v. *Dilworth Co.,* 322 U.S. 327), but the proceeds of such sales may be used to increase the taxpayer's total net income and, thus, to increase the fairly apportioned part of that income which the State can tax. *Butler Bros.* v. *McColgan,* 315 U.S. 501; *Underwood Typewriter Co.* v. *Chamberlain,* 254 U.S. 113; *Northwestern Cement Co.* v. *Minnesota,* 358 U.S. 450. The fact that the total tax paid one State is increased by increased sales in other States does not mean that the tax is imposed *on* the constitutionally immune sales in other States. Similarly, any apportionment of a company's net income between the part that is taxable and the part that is constitutionally immune necessarily implies that all overhead expenses need not be deducted from the taxable gross income alone but the deduction can be reduced to the extent that, under a fair apportionment formula, the overhead expenses are attributable to constitutionally immune sales. *E.g., United States Glue Co.* v. *Town of Oak Creek,* 247 U.S. 321.

What the foregoing examples and decisions demonstrate is that it is impossible to draw a meaningful

conclusion about the subject matter of a tax on net income from the simple demonstration that the tax would have been less if a single, arbitrarily selected, item of gross income had been eliminated from the computation and everything else left the same. For in any given case it may be utterly inappropriate to leave everything the same. The computation may or may not involve deductions or allocation of items of gross income or cost. If it does, the addition or exclusion of an item of gross income—even of a non-taxable item—may call for a new allocation substantially affecting the net taxable income that results. If different allocations are reasonable, and if, after the allocations are made, appropriate deductions or exclusions are then allowed for that part of any constitutionally immune item that enters into the net income, the resulting tax cannot be said to be a tax *on* the immune item. Congress need not allocate items of expense or income in whatever way produces the least tax.

In short, the fallacy in the formula proffered by respondent and accepted by the court below is that it assumes that the same allocations and subtractions must be made on account of the reserve fund regardless of whether the taxpayer company has, or has not, received income from State bonds. The 1959 Act prescribes different allocations and subtractions. The question, however, is not whether the tax is more, but whether the changed apportionment is reasonable. We turn next to that question.

763-293—65——3

B. THE 1959 ACT MAKES A FAIR APPORTIONMENT OF THE ANNUAL ADDITION TO THE RESERVE FOR SHAREHOLDERS

In the Life Insurance Company Income Tax Act of 1959 Congress determined to adhere to a well-established policy and provide that in computing the net income of a life insurance company there should be an allowance for the annual addition to the policyholders' reserve. Since a life insurance company's income usually includes income from several sources, this determination, as we have seen (pp. 22–29, *supra*), raised a problem of allocation or apportionment: to which dollars of gross income do the dollars added to the reserve relate—exclusively to taxable dollars, exclusively (or so far as possible) to non-taxable dollars, or ratably to all?

There is no precise analogy for solving the problem. The policyholders' reserve of a life insurance company is unique. Congress evidently concluded that the interest of the policyholders in the reserve was such that the problem of apportionment could be likened to that of the allocation of taxable and tax-exempt income among the several beneficiaries of a trust. If $50,000 of income, made up of $25,000 dividends and $25,000 interest from State bonds, is received by *A* under a trust charging him with paying the first $40,000 of income annually to *B* and the rest to himself, *A* would be taxed as if he paid out four-fifths and retained one-fifth of each kind of income, *i.e.*, he would be taxed on $5,000 and receive $5,000 tax free. Similarly, in the 1959 Act Congress treated the additions to the reserve as if the policy-

holders like *B* were the beneficiaries of a trust and provided for allocating a ratable share of each item of income to the policyholders and to the company.

Respondent denies the appositeness of the analogy and asserts that the statutory treatment is a verbal form lacking reality. In its view the annual increase in its liabilities to policyholders (*i.e.*, the annual additions to the reserve) is nothing more than an accruing "cost" of doing business and the so-called "exclusion" of the "policyholders' share" of its income, equal to the reserve addition, is in substance but a "deduction" allowed for that cost. Respondent then contends that a partial disallowance of what it assumes to be an otherwise allowable deduction, solely because of the receipt of tax-exempt interest, results in imposing a tax on that interest.

We are content to assume the relevance of respondent's analysis of the addition to the reserve in terms of cost but we challenge its assumption that viewed as an accruing cost the full addition to the reserve must be charged against the taxable gross income and none against the income from State bonds. As we now show, it is a fair and reasonable, and therefore constitutional, apportionment to limit the deduction from taxable income to that part of the "costs"—*i.e.*, to that part of the addition to the reserve—allocable to the production of the taxable income. We will then demonstrate that this is an *a fortiori* case because the special interests of the policyholders in the reserve furnish additional justification for the statutory formula.

763-293—65——4

1. *Treating the policyholders' reserve as a deduction for deferred costs, it is fair and reasonable to limit the deduction to that part of the costs allocable to the production of taxable income*

In order to analyze the Act and the reasonableness of its allocations in respondent's terms, it is necessary to restate the taxing formula in terms which accord with respondent's view of its function. In terms, starting with investment income, the Act allows an "exclusion" for the full amount of the addition to the reserve by setting it aside as the policyholders' share, plus a "deduction" for only a *pro rata* part of the tax-exempt interest (equal to the fraction that the "company's share" is of the total investment income). The result would be exactly the same; however, if the tax-exempt interest were first excluded in full and a "deduction" were then allowed only for that part of the addition to the reserve that the taxable income is of the total income—*i.e.*, with a deduction being allowed for only 90 percent of the addition to the reserve if only 90 percent of the investment income consists of taxable items.[11] The lat-

[11] If a company has an investment yield (y) of $100, tax-exempt interest (i) of $10, and a reserve addition (r) of $80, the Act would in terms allow an "exclusion" equal to the full amount of the reserve addition, $80 ($r$), plus a "deduction" for the "company's share" (20/100) of the tax-exempt interest, $2, thus allowing total exclusions or reductions of $82, and leaving $18, subject to tax.

If an exclusion is first allowed for the full amount of the tax-exempt interest, $10, and a deduction is then allowed for the same fraction (90/100) of the reserve addition ($80) as the taxable

ter is the computation that respondent sees as the substance of the statutory formula and which we will consider here.

The apportionment thus made is an entirely proper allocation of a cost of producing investment income between the taxable income and the income from State bonds. An insurance company produces income primarily by obtaining funds from policyholders (in the form of premiums) and investing them in income-producing assets. As the *quid pro quo* for its use of the policyholders' money, it undertakes to pay death benefits and other claims which exceed in amount the premiums it receives from policyholders. The excess of those ultimate liabilities over the premiums received is paid by the company in exchange for the use of the money which it invests and is the major "cost" incurred in the production of its investment income. Only if its investment income is greater than that cost is the company's business profitable. In determining

---

income is of the total income, or $72, the result is the same; the exclusions or deductions total $82, and again only $18 is subject to tax.

Mathematicians will also readily perceive that the formulae for computing the total deductions or exclusions under the two approaches —i.*e.*, $(r+\left(\frac{y-r}{y}\right)i$, under the Act, and $i+\left(\frac{y-i}{y}\right)r$, under the "deduction" theory) are in fact mathematical equivalents, both reducing to $r+i-\left(\frac{r}{y}\right)i$.

The alternative methods of computation are set out in both tabular and graphic form in Appendix A (Schs. A and B and Chart), pp. 79–83, *infra*.

the company's net income from investments, therefore, a deduction ought plainly to be allowed for the payments it is required to make to policyholders. That is essentially what the 1959 Act, seen in respondent's terms, does. While the company's liabilities are deferred and need not be satisfied until the events occur entitling the policyholders to payment, the Act in effect allows the company to "accrue" the cost of using the funds paid in as premiums by allowing it to offset against its current income an addition to a reserve to reflect the maturing of the actuarially predicted policyholder claims. And since the funds so acquired are used to produce investment income, the addition to the reserve is a cost directly attributable to the production of the investment income.

If the company's investment income, earned at the "cost" of the annual addition to the reserve, were entirely from taxable securities, there would be no problem, and the cost would be deductible in full. In fact, the income is partly from taxable securities and partly from tax-exempt securities, and unless a deduction must be allowed against taxable income for the costs of producing tax-exempt income, it becomes appropriate, if not necessary, to allocate the cost between the two kinds of income produced by it. The solution adopted by the Act (restructured in respondent's terms) is the obvious and customary one: it allocates the cost in proportion to the amount of each kind of income produced by the investment of the funds. If 90 percent of the company's investment income is from taxable sources, 90 percent of the addition to the reserve is treated as a cost of producing taxable in-

come and a deduction in that amount is allowed. If only 70 percent of the investment income is taxable, only 70 percent of the reserve addition is deductible; the balance is treated as a cost of producing tax-exempt interest properly to be charged, not against the taxable income, but against the tax-free income it produces. Not only is that allocation perfectly reasonable but there is, we submit, no fairer method by which the allocation could be made. Certainly *some* part of the cost of using the policyholders' funds is attributable to the production of the tax-exempt interest, and unless Congress is constitutionally required to allow the costs of producing tax-exempt income to be offset against taxable income, so reasonable an allocation can hardly be subject to challenge.

The assumed constitutional prohibition against a federal tax on interest from State bonds does not require Congress, in providing for the computation of net income, to allow deductions from taxable income for items of expense that are fairly attributable to the production of non-taxable income from State bonds. There is no more reason why Congress should allow such a deduction for the costs of acquiring and holding State bonds (producing untaxed monetary income) than there is why it should allow a deduction for the costs of maintaining an automobile for personal use (producing untaxed real income). The explicit provision, contained in the revenue laws since 1934, disallowing any deduction for expenses "allocable" to tax-exempt interest (§ 265(1)) is no more special or discriminatory than is the provision explicitly disallowing "personal, living, or family ex-

penses" (§ 262). Both are manifestations of the general principle that deductions are usually allowed only for the cost of producing taxable income. The expenses of holding a State bond are not deductible, in short, for precisely the same reason that the expenses of maintaining a home, going on a vacation, or taking music lessons are not: they all belong to the great universe of expenses which lack the requisite nexus to the production of taxable income to justify charging them off as a cost of producing that income.

And just as no deduction at all need be allowed for expenses which are not attributable at all to the production of taxable income, so also a full deduction need not be allowed for expenses that are attributable only in part to the production of taxable income. As we have seen, the cost of an automobile that is used both to produce taxable income and for personal purposes may be allocated in proportion to the use of the automobile and the deduction may be limited to the portion allocated to its use for business purposes (see pp. 24–25, *supra*). By the same token, costs incurred to produce both taxable and tax-exempt income may be allocated in the proportion that they produce the two kinds of income and the deduction may be confined to the portion allocated to the production of the taxable income. Nothing in the constitutional doctrines pertaining to intergovernmental immunities requires Congress to allow a deduction from taxable income of the cost of producing income held constitutionally immune from federal tax.

Two decisions of this Court squarely sustain the foregoing proposition. *Denman* v. *Slayton*, 282 U.S.

514; *Helvering* v. *Independent Life Ins. Co.*, 292 U.S. 371. The earlier cases are not to the contrary. For convenience we consider them all in chronological order.

In *National Life Ins. Co.* v. *United States*, 277 U.S. 508, the Court held unconstitutional provisions of the Revenue Act of 1921 which allowed a deduction for additions to the policyholders' reserves only to the extent that the additions exceeded tax-exempt interest from State bonds. The Court did not purport to condemn a limitation of an expense deduction to the part properly allocable as the cost of producing taxable, rather than tax-exempt, income, for the provisions of the Act suggested no such purpose. The Act suffered from the vice that instead of providing for a pro-rata allocation, it arbitrarily treated the costs of holding and using the reserve—the annual addition—as attributable first to the production of State bond interest to the full extent of that income and only the remainder as allocable to the taxable income. That was as arbitrary, in its way, as the respondent's claim that all the costs must be attributed only to the production of taxable income. The Court viewed the statute as merely a devious attempt to offset the immunity of interest from State bonds by denial of an *unrelated* deduction to the extent of the tax-exempt interest received and held only that "Congress had no power purposely and directly to tax state obligations by refusing to their owners deductions allowed to others." 277 U.S. at 522. The deduction allowed to others but disallowed to the recipient of State bond interest, to the extent

of that interest, was the fairly allocable share of the cost of producing the taxable income. It was therefore true to say that the insurance companies were being subjected to a higher tax upon their taxable income *merely* because they received income from State bonds. There is nothing in *National Life* inconsistent with our position in the present case. Here the fairly allocable share of the cost of producing the taxable income is allowed as a deduction and the tax is higher only because the receipt of income from State bonds makes it unfair to charge to taxable income the non-taxable income's fair share of the total investment cost.

In *Missouri Ins. Co.* v. *Gehner*, 281 U.S. 313, the Court did decide a question somewhat analogous to that presented here, holding that, in determining the taxable net worth of a corporation, a State could not apportion the corporation's liabilities between taxable and tax-exempt assets and then limit the deduction for liabilities to those allocable to taxable assets. Even if later cases had not removed any ground for claiming that *Gehner* invalidates a federal statute limiting expense deductions to the apportionable share of an over-all cost, we would believe that *Gehner* was distinguishable from the present case on a number of grounds: (i) it involved the invocation of the federal immunity from State taxation, an immunity which this Court has, since *McCulloch* v. *Maryland*, 4 Wheat. 316, 435–436, recognized to be broader than the immunity enjoyed by the State from federal taxation (see *New York* v. *United States*, 326 U.S. 572, 576–577); (ii) it concerned the scope of a federal im-

munity statute (31 U.S.C. 742) as well as the constitutional immunity,[12] and, indeed, has since been characterized by this Court as a decision based on that statute (*New Jersey Realty Title Ins. Co.* v. *Division of Tax Appeals,* 338 U.S. 665, 674); (iii) it did not present an issue of allocation of expenses between taxable and tax-exempt income, but rather an allocation of liabilities between taxable and tax-exempt assets; (iv) it involved a tax on property rather than one on income, which is important because a tax on income, unlike the tax on property, is already one step removed from the bonds themselves.

Whatever the merits of the *Gehner* ruling upon its own facts, two later decisions make it plain that neither *National Life* nor *Gehner* denies the power of Congress, in levying on taxable net income, to withhold a deduction for the expense of producing tax-exempt income and, in aid of that purpose, to limit the deduction of a single item of cost to the share fairly apportionable to the production of the taxable portion of the gross income.

In *Denman* v. *Slayton,* 282 U.S. 514, the taxpayer had $65,000 of income from State bonds and still larger income from taxable sources. From his taxable

[12] The broad scope of the federal immunity statute was confirmed by an amendment enacted in 1959 to make it clear that (73 Stat. 622):

> "This exemption extends to every form of taxation that would require that either the obligations or the interest thereon, or both, be considered, directly or indirectly, in the computation of the tax, except non-discriminatory franchise or other nonproperty taxes in lieu thereof imposed on corporations and except estate taxes or inheritance taxes."

income he subtracted $78,000 paid as interest on money borrowed for the purpose of purchasing the State bonds. The Commissioner disallowed the deduction under a statutory provision (now § 265(2)) permitting the deduction of interest paid on indebtedness "except on indebtedness incurred or continued to purchase or carry obligations or securities * * * the interest upon which is wholly exempt from taxation under this title * * *." 282 U.S. at 518. The taxpayer, relying upon *National Life* and *Gehner*, argued that the denial of the deduction violated the constitutional immunity of the income from State bonds because the taxpayer had been subjected to greater tax burdens by reason of their ownership. The Court sustained the Commissioner, ignoring *Gehner* and distinguishing *National Life*. Obviously the case holds that the exclusion of State-bond interest from the computation of net income subject to tax makes it permissible also to exclude from the computation the cost of producing the non-taxable interest.

Since the expense involved in *Denman* v. *Slayton* was incurred specifically and solely to produce the tax-exempt income, that case did not involve the apportionment of a single item of expense incurred in producing both taxable and tax-exempt income. The underlying principle, however, is the same in both cases. If one obtains a single loan of $100,000 and uses half to buy corporate stocks and half to buy State bonds, only half the interest paid on the loan need be allowed as a deduction; the other half is no more fairly deductible from the income from the stocks than it would be if one obtained two separate loans of

$50,000 and used one for the sole and specific purpose of purchasing State bonds.

Three Terms later, in *Helvering* v. *Independent Life Ins. Co.*, 292 U.S. 371, the underlying principle of *Denman* v. *Slayton* was applied to the apportionment of a single item of expense. The Revenue Act of 1921 taxed only a life insurance company's income from interest, dividends, and rentals, and it allowed deductions for taxes, depreciation, or other expenses paid on real estate held for rental. The Act specifically denied those deductions, however, if any part of the rental property was occupied by the company itself, unless the company included in gross income a figure for the rental value of the space it occupied sufficient to provide a net income from the building equal to 4 percent of the book value of the whole building. The company argued and the Court agreed that a tax on the rental value of property the company owned and used would be unconstitutional "for that would be to lay a direct tax requiring apportionment." 292 U.S. at 378. Moreover, the statute plainly increased the company's taxable income by denying all or part of an expense deduction if it chose to use part of a building it owned and rented. Nevertheless, the Court rejected the company's argument, based on *National Life*, that the statute imposed an unconstitutional tax on the rental value of the owner's use of his own building. The Court held that the tax-exempt rental value of the space occupied by the company could be used to apportion between taxable and tax-exempt income the otherwise wholly deductible expenses for maintaining the building (at p. 380):

> The statute does not prescribe any basis for the apportionment of expenses between space used by the company and that for which it receives rent. The calculation indicated [the use of imputed rental value of the space occupied by the company] operates as such an apportionment where the rents received are more than four per cent of book value, but less than that amount plus expenses. In such cases the addition, called rental value of space occupied by the company, is employed to permit a deduction on account of expenses. * * *

To sustain the propriety of limiting a deduction by an apportionment of an item of expense the Court likened the issue before it to the exemption for income from State bonds and invoked the decision in *Denman* v. *Slayton* holding that Congress can limit an expense deduction by eliminating the amount attributable to tax-exempt income. Accordingly, the Court concluded, the statute did "not lay a tax upon respondent's building or the rental value of the space occupied by it or upon any part of either" (292 U.S. at 381). Once again the *National Life* case was distinguished and *Missouri* v. *Gehner* was ignored.[13]

[13] The 1959 Act contains a provision similar to that of the 1921 Act. In determining "investment yield," a life insurance company is allowed deductions for real estate expenses and depreciation. § 804(c) (2) and (3). The deductions are limited, however, "to an amount which bears the same ratio" to the total expenses "as the rental value of the space" not occupied by the company for insurance purposes "bears to the rental value of the entire property." § 804(c)(3). This continuing provision for the taxation of insurance companies, which differs from that in the *Independent Life* case only in that the present method of apportionment is more equitable, has not been challenged since the *Independent Life* case.

Decisions in related areas also show that property or income constitutionally immune as the subject of a tax may be included in making a fair apportionment as part of the computation of a tax on a proper subject, even though the effect is to increase the tax. For example, in taxing the part of a company's net income apportionable to business done within its borders a State may take into account extra-State sales which, so far as it is concerned, are constitutionally immune from tax; and this is true even though the result of an increase in the immune extra-State sales, all other things being equal, is the payment of a higher State tax. *E.g., Butler Brothers* v. *McColgan,* 315 U.S. 501; *Underwood Typewriter Co.* v. *Chamberlain,* 254 U.S. 113; *Northwest Cement Co.* v. *Minnesota,* 358 U.S. 450. And, of course, every decision sustaining an apportionment of net income between taxable sources and non-taxable sources, such as out-of-State business, is in effect an apportionment of items of expense limiting the deductions made from gross receipts from taxable sources. *E.g., United States Glue Co.* v. *Town of Oak Creek,* 247 U.S. 321. Except for the *Gehner* decision, the law has always been the same for taxes measured by the value of property. *Maxwell* v. *Bugbee,* 250 U.S. 525. Thus, while Texas cannot constitutionally tax real property located in Michigan (*Western Union Telegraph Co.* v. *Kansas,* 216 U.S. 1; *Cream of Wheat Co.* v. *County of Grand Forks,* 253 U.S. 325), it can take into account the value of such real property in determining the total net worth of a corporation, a fairly apportioned part of which Texas may tax. *Ford Motor Co.* v. *Beau-*

champ, 308 U.S. 331; *International Harvester Co.* v. *Evatt*, 329 U.S. 416. The fact that the Texas tax is increased by the ownership of an additional factory in Michigan does not mean that Texas is taxing real property in Michigan. It is, of course, equally clear that, in taxing the part of the net worth of a corporation which is properly allocable to the taxing State, a fairly apportioned part of the liabilities of the corporation may be denied a deduction because it is attributable to constitutionally immune property in other States (*ibid.*).

In short, the principles applied by Congress in the Life Insurance Company Income Tax Act of 1959 and sustained by this Court in the *Independent Life* case are merely the established doctrines regularly applied by the Court where it has been called upon to determine whether a tax has been imposed on constitutionally immune income or property. Their application to the present case is neither novel nor debatable.

Those principles control the present case. If the reserve exclusion in the Life Insurance Company Income Tax Act of 1959 is treated, as respondent contends it should be, as a deduction for one of the costs of producing the company's total investment income, then the *Independent Life* case is dispositive of the power of Congress to limit the deduction by allocating part of the cost to the tax-exempt income the company receives. Just as the tax-exempt rental value of the part of its property occupied by the Independent Life Insurance Company could properly be taken into account to limit the deduction for the costs of maintaining the building to the portion of the costs fairly

allocable to the production of taxable rental income, so can the tax-exempt interest realized by respondent properly be taken into account to limit the deduction for the cost of producing its investment income (the required addition to the reserve) to the portion fairly allocable—by an allocation formula far more reasonable than that used in *Independent Life*—to the production of taxable investment income. In one case a deduction is reduced because it is partly allocable to an owner's tax-exempt use of his own property; in the other, a deduction is limited because it is partly allocable to the receipt of tax-exempt interest. And just as the *Independent Life* case involved no tax on the rental value of the property used by the owner, the present case involves no tax on the interest from State bonds.

2. The special interests of the policyholders in the reserve furnish additional justification for the apportionment

Although it is enough to sustain our case to show that the computations prescribed by the 1959 Act make a fair apportionment of the annual addition to the policyholders' reserve treating the addition as a cost or expense, we submit that, in truth, the reserve has characteristics which make this a far stronger case for upholding the apportionment and resulting limitation on the deduction from gross taxable income. For while the policyholders are neither the legal nor equitable owners of the reserve, it is created to protect them, and is treated by the industry as a special fund for their benefit, to such an extent as to make the tax treatment of annual additions to the

reserve fairly analogous to the problems arising upon the distribution to two or more beneficiaries of income from taxable and tax-exempt sources.

Congress' conception, as we have seen, was that the undivided part of the insurance company's assets represented by the policyholder reserves constitutes a "trust fund" held for the ultimate benefit of the policyholders, and therefore, for tax purposes, it should be treated as a separate entity from the "company." Congress accordingly treated the required annual addition to the reserve simply as a division between two entities of the income earned from the investment of their commingled assets, the share going to the "trust fund" for the benefit of the policyholders being described as the "policyholders' share" and the share going to the "company" being described as the "company's share." The "policyholders' share" of the income, in short, was "excluded" from the company's tax base, not because it was thought of as a deductible cost, but because, on Congress' conception of the nature of the reserve funds, it was simply not "the company's" income.[14] The computations resulting from this approach are somewhat different from those resulting from treating the addition as an item of cost

[14] The income added to the reserves was not taxed to the "trust fund" itself, regarded as a separate taxable entity, presumably because of a judgment of tax policy that it was desirable to permit a tax-free accumulation of funds to finance death benefits. Compare the exemptions accorded to qualified employee pension trusts (§§ 401–404, 501(a)) and to various kinds of fraternal, employee, and benevolent associations which provide accident or death benefits (§ 501(c) (8)–(12)).

but, since both lead to the same result,[15] proof of the fairness and constitutionality of the one tends to confirm the fairness and constitutionality of the other.

The distinctive character of policyholder reserves which was recognized by Congress derives primarily from their treatment under State law. In order to protect policyholders from putting their life's savings into insurance policies only to find an empty barrel when their claims fall due, life insurance companies are generally required under State law to retain on hand at all times net assets at least equal to their reserves for policyholder liabilities computed on prescribed mortality and interest assumptions. The type of investments insurance companies may make with their reserve funds is also closely regulated by State law. Inasmuch as the reserves required to be maintained increase each year by the rate of interest assumed in computing the reserves, the company is required each year to increase the amount of the net assets it retains on hand. As a practical matter, that increase can come only from the income earned from the investment of the assets. The practical result of the State regulation, then, is that a part of the income received each year (equal to the required interest on the reserve) is "frozen"; it is not available for distribution but must be held back and placed in legal investments in order to assure the ability of the company to pay the policyholder claims as they fall due.

The extensive protection thus afforded the policyholders' interests under State law, and the practical

[15] Indeed, they reduce mathematically to the same formula. See p. 33, *supra*.

interest the policyholders have in the income yield from the assets (necessary in order to maintain the increasing reserve), have led to a widespread characterization of the undivided part of the assets equal to the reserves as a "trust fund" held for the benefit of the policyholders which does not beneficially "belong" to the company, at least in a practical, economic sense.[16] Thus the Institute of Life Insurance refers to the reserve funds (*i.e.*, the undivided part of the assets counterbalancing the reserve liability) as the "policyholders' funds,"[17] and standard texts speak of the reserve as a fund which "does not belong to the company but is held in trust for the policyholder at an assumed rate of interest."[18] Leading judicial opinions have for many years spoken in a similar vein, and Judge Learned Hand has described policyholders as "associates" in the "financial operations of the whole group, which thus makes profits or losses as such."[19]

To be sure, the restrictions imposed by State law on what an insurance company may do with the share of its assets equal to the reserves do not, under traditional concepts, amount to a change in the "own-

[16] *Wurzel, Tax-Exempt Interest of Life Insurance Companies*, 70 Yale L.J., 15, 40–44.

[17] Institute of Life Insurance, *Life Insurance Fact Book*, 1959, pp. 61–64.

[18] Huebner & Black, *Life Insurance*, p. 6.

[19] *New York Life Ins. Co.* v. *Bowers*, 39 F. 2d 557, 558–559 (C.A. 2), affirmed, 283 U.S. 242; see also *Penn Mutual Co.* v. *Lederer*, 252 U.S. 523, 534.

ership" of the assets. They do, however, establish a significant difference in the capacity in which the company holds the two shares of the assets (the undivided share equal to the reserves and the balance). The basic policy judgment made by Congress was that income which is accumulated and held for the payment of death benefits to policyholders ought to be exempt from tax but that income received by an insurance company which is free of the requirement that it be held for the benefit of the policyholders ought to be taxed. Having made that judgment, it was patently reasonable for Congress, in the light of the significant difference in the restrictions imposed by State law on the company's use of the two shares of its assets and income, to treat the company as acting in a dual capacity and then to exempt the income received by it in one capacity (the income required to be held for the benefit of the policyholders) while taxing the income received in the other (the income free of the restrictions imposed by State law). While the capacity in which a life insurance company holds the undivided share of its assets equal to the policyholder reserves may not technically be that of a "trustee" under common-law concepts, Congress is no more bound by common-law concepts in determining what it will recognize as separate entities for tax purposes (here, the company *qua* holder of the reserve funds and the company *qua* holder of the remaining assets) than it is in determining what it will recognize as "ownership". Cf. *Burnet* v. *Wells*, 289 U.S. 670; *Corliss* v. *Bowers*,

281 U.S. 376; *Reinecke* v. *Smith*, 289 U.S. 172.[20] There being a real difference in the company's relationship to the two shares of its assets, Congress, in order to further its policy of permitting a tax-free accumulation of income for purposes of paying death benefits, could properly view a life insurance company as constituting a dual entity and tax it accordingly.

Having excluded a share of the investment income from the tax base on the theory that it constituted a "division" of the income between what it regarded as two distinct entities—one tax-exempt (the "trust fund" for the policyholders) and the other taxable (the "company")—it was plainly reasonable for Congress to treat the two shares of the income as consist-

[20] In *Burnet* v. *Wells*, in upholding a tax on the settlor of a trust on the income of the trust used to pay premiums on insurance policies on his life, Mr. Justice Cardozo set forth the applicable constitutional standards in terms equally applicable here (pp. 678–679):

> Refinements of title are without controlling force when a statute, unmistakable in meaning, is assailed by a taxpayer as overpassing the bounds of reason, an exercise by the lawmakers of arbitrary power. In such circumstances the question is no longer whether the concept of ownership reflected in the statute is to be squared with the concept embodied, more or less vaguely, in common law traditions. The question is whether it is one that an enlightened legislator might act upon without affront to justice. * * * To overcome this statute the taxpayer must show that in attributing to him the ownership of the income of the trusts, or something fairly to be dealt with as equivalent to ownership, the lawmakers have done a wholly arbitrary thing, have found equivalence where there was none nor anything approaching it, and laid a burden unrelated to privilege or benefit. * * *

ing of a pro rata share of each item of income. That is the method of allocation that has long been utilized, without challenge, to solve the analogous problem of dividing the income of a trust among the several beneficiaries (see pp. 26–27, *supra*), and there is even more justification for its use here. Since the "corpus" of the "trust fund" for the policyholders consists of an undivided share of all the assets, it necessarily contributes equally to the production of all of the kinds of income derived from the investment of those assets. Thus the allocation of a pro rata share of all the income to the policyholders' reserves is justified, not only because of the lack of any more rational basis for allocation (as in the trust case), but also because the reserve funds in fact contribute equally to its production.

Respondent argues that the statute's treatment of the addition to the policyholder reserves as a "division" of income, with an "exclusion" then being allowed for the "policyholders' share," is mere sleight-of-hand, a use of labels invented by Congress in an effort, while accomplishing the same substantive results, to avoid the constitutional difficulties that would (in respondent's view) be presented by a partial disallowance of the "deduction" for the reserve addition because of the receipt of tax-exempt interest. We do not pause to answer the criticism of the statutory terms because as we have shown (pp. 32–45, *supra*) the supposed constitutional difficulties arising from the treatment of the reserve addition as a "deduction" do not exist, and the apportionment prescribed by Congress would be constitutional even if the analysis

in terms of cost were a full and accurate portrayal. The truth would seem to be that respondent's description is incomplete because it overlooks the special characteristics of the policyholders' reserve, just as the analogy to trust income may be imperfect because the policyholders have no property interest. There is no occasion to debate which analogy is the more persuasive. Both lead to the same conclusion—that there is no tax on a life insurance company's income from State bonds violating the assumed constitutional limitation—and therefore each approach tends to show the fairness of the other.

II

SINCE THE STATUTORY APPORTIONMENT DOES NOT VIOLATE THE ASSUMED CONSTITUTIONAL PROHIBITION AGAINST A TAX ON STATE-BOND INTEREST, THE "EXCEPTION CLAUSES" ARE INOPERATIVE

By express enactment the "exception clauses" invoked by respondent (§§ 804(a)(6), 809(b)(4)) are inoperative only if it is established that the statutory formula—

> results in the imposition of a tax on—
>
> (A) Any interest which under section 103 is excluded from gross income [*i.e.*, interest from State bonds] * * *

If the effect of this provision is to require adjustment only where the statutory formula results in the imposition of a tax on State-bond interest in the sense that the tax could not be sustained consistently with the once-established basic consitutional immunity of State-bond interest from federal tax, then the provision is inoperable in the present case because, as we

have seen, the formula does not violate the assumed constitutional prohibition. If the exception clauses have some other meaning, the task remains of establishing that meaning and determining whether the case falls within it.

In our view the function of the exception is only to provide for an adjustment if the statutory formula cannot be applied consistently with the established constitutional immunity of State bonds. In every statute taxing life insurance companies since 1921 Congress has recognized that the annual addition to the policyholders' reserves, for all of which a deduction or exclusion is allowed, consists in part of tax-exempt income, and that to allow both to be deducted or excluded in full is to make a double allowance. The Revenue Act of 1942 attempted to avoid the duplication on an industry-wide basis by reducing the deduction for the reserve in the proportion that the tax-exempt interest received by the whole industry bore to its total investment yield. 56 Stat. 870. When it was proposed to replace the industry-wide method of computing the reserve deduction by a company calculation, several formulae, including the formula ultimately incorporated in the 1959 Act, were advanced for the express purpose of preventing a double allowance.[21] Life insurance companies holding more than 70 percent of all life insurance company assets in the United States agreed that the apportionment ultimately incorporated into the statute

[21] Compare H.R. 4245, 86th Cong., 1st Sess., with the statute as enacted.

should be adopted [22] but others disagreed and the opponents of the formula contended that it imposed an unconstitutional tax on interest from State bonds.[23] As we show below in detailing the legislative history, not only did they believe that the tax was on State bonds, but they feared that, to sustain it, the Treasury might attack the basic doctrine that a tax on State-bond interest is unconstitutional. The Treasury denied that the formula imposed a tax on State-bond interest or that it had any such intent. As we see it, Congress in enacting the exception clause barred an attack upon the basic constitutional immunity but left the subsidiary question to the courts by providing for an adjustment in the event that its formula and the basic constitutional immunity could not survive together because, in the constitutional sense, the tax was imposed "on" the interest.

Respondents argued in the court below that Congress set up its own standard for determining whether a tax was on State-bond interest. The test prescribed, they said, was to ask whether under the statutory formula the tax would have been lower but for the receipt of the income from State bonds. We submit that this interpretation is untenable on the face of the statute, and that the legislative history as well as the interrelationship between the formula and "exception" clause shows our interpretation to be correct.

---

[22] 105 Cong. Rec. 8402. See *infra*, p. 74.

[23] See *infra*, p. 65.

A. THE INTERRELATIONSHIP BETWEEN THE SEVERAL PARTS OF THE STATUTE SHOWS THAT THE FUNCTION OF THE EXCEPTION CLAUSE IS TO PROVIDE AN ADJUSTMENT ONLY IF THE STATUTORY FORMULA VIOLATES THE ASSUMED CONSTITUTIONAL PROHIBITION AGAINST A TAX ON INTEREST FROM STATE BONDS

The inclusion of both the apportionment formula and the "exception" clause in the same statute makes it apparent that the "exception" clause must refer to some external standard for determining whether the formula imposes a tax upon interest from State bonds. The most likely standard—looking only to the face of the 1959 Act—is the body of constitutional law developing the principle that the federal government has no power to tax State borrowing. The likely occasion for incorporating the constitutional doctrine into the statute was the risk, which Congress desired to obviate, that if the formula were held to impose a tax upon State-bond interest, contrary to the congressional expectation, the Treasury would seek to sustain it by asking the Court to overrule the basic constitutional immunity.

If Congress had had some independent but self-contained standard in mind, it would surely have decided for itself whether the apportionment formula or the standard provided by the exception should prevail. There was no mystery about the operation of the specific formula which Congress wrote into the law and for which it expressed a preference if the formula could be reconciled with some other standard which Congress regarded as superior but about the application of which it was uncertain. If Congress had had a specific, self-willed standard in mind,

it would have known better than anyone else whether that standard was consistent with the formula and, if it was inconsistent, Congress could, and undoubtedly would, have decided which of the two should prevail. It would have been idle for Congress to instruct the courts to determine whether what it clearly enacted in one part of a statute is inconsistent with what it "intended" to enact as some wholly internal self-contained standard in another part; for the question would reduce itself to an inquiry whether Congress intended what it did.[24] The only intelligible explanation of the co-existence of the two provisions is the one we suggest: that Congress intended to make the formula effective if it could be done consistently with some superior external standard with which the courts were more familiar than the Congress and whose application to the circumstances was the subject of congressional debate. The most natural point of reference having those characteristics is the body of constitutional law described above.

The bizarre implications of imputing to Congress a purpose to adopt its own independent standard of

[24] We are not dealing here with a situation in which an enacted formula, although operational in the generality of cases as enacted, may in a few specific applications run counter to the policy expressed by Congress in another provision. The formula governing the allowances or deductions from a life insurance company's investment income operate in the same manner and the exception clause comes into play to the same extent, if at all, in every case in which the company receives State-bond interest; and State-bond interest is expressly mentioned in the apportionment formula. Accordingly, this cannot be analyzed as a case in which Congress was guarding against occasional contingencies that might arise but were not part of the generality of the cases with which it was dealing.

what a tax is "on" are sharply illustrated by the particular standard respondent attributes to Congress—namely, the "but-for" test employed by the court below. With that standard read into the "exception" clause as a specific statutory directive understood by Congress, the Act is reduced to saying: (1) the tax shall be equal to the tax rate times an amount equal to

> taxable income *plus* tax-exempt interest *minus* reserve addition *minus* company's share of tax-exempt interest

"except" that (2) the tax shall not be greater than it would be if the tax-exempt interest were zero. The result, of course, is self-contradiction. Wherever there is tax-exempt interest the tax under (1) will be greater than if there were none because the total amount of tax-exempt interest, if there is any, will always be greater than the company's share. If Congress had "wanted" the tax to be no greater than it would be if the company had not received the tax-exempt interest, it had only to eliminate the tax-exempt interest from the formula. No rational body would consciously set out to accomplish that result by repealing in one provision what it enacted in another.

Since Congress could not actually have intended both what the taxing provisions expressly say—that tax-exempt interest shall be taken into account—and what respondent claims the "exception" clause means—that the tax-exempt interest shall not be taken into account—respondent seeks to avoid the dilemma by asserting that Congress did not "understand" the taxing formula and how it would operate

(Br. in Opp. 9–10). That is, in order to conclude that Congress meant by the "exception" clause something which it did not say—that a tax should be deemed to be imposed "on" tax-exempt interest whenever the tax is higher because of the interest, regardless of the reasonableness of the allocation used—the Court is asked to hold that Congress did not understand what it did say in the taxing provisions.

The suggestion that Congress did not understand that the result of treating a share of the tax-exempt interest as going into the policyholder reserves and allowing the company to deduct (in addition to the reserve exclusion) only a fraction of the tax-exempt interest would be to cause the tax to be higher than if the tax-exempt interest were disregarded altogether, is wholly unacceptable. The courts cannot say that Congress did not understand the meaning—the only meaning—of its own enactment. Congress enacted the definitions of "gain from operations" and "taxable investment income" into law, and there is no dispute about what those provisions expressly say. It would be a slander on the legislative process for us to undertake to prove, or for the courts to inquire, whether Congress "understood" what the definitions unquestionably say about every situation they cover. The "exception" clauses permit of only one interpretation which gives them a function rationally consistent with the enactment of the formula—they refer to the external constitutional principles determining whether a tax is on State-bond interest as this Court would apply them. The meaning of the "exception" clauses is therefore fixed by a presumption of law—*i.e.*, a

conclusive presumption—that Congress acted rationally and not from schizophrenia in simultaneously enacting the two sections.

We should acknowledge one logically possible exception: it is rationally conceivable that Congress intended to refer, for an external standard, not to the whole body of constitutional law relevant to whether a tax is "on" State-bond interest but only to a few selected decisions to be interpreted in isolation without regard to other equally material precedents; and respondent would find such decisions in *National Life Ins. Co.* v. *United States*, 277 U.S. 508, and *Missouri* v. *Gehner*, 281 U.S. 313. Such legislative conduct, while conceivable, is utterly implausible. If Congress had understood those particular decisions to lay down the "but for" rule, it would hardly have enacted the exception clause; the only sensible course would have been to modify or abandon the apportionment formula. If there was debate about the meaning of those decisions and if Congress intended the standard to be derived from reading them in isolation, then it would have written the "exception" clause so as to refer to the specific cases, instead of adopting a general concept developed in a whole series of decisions. Under our legal system, moreover, the effect of any particular precedent is determined, not by exegesis from the opinion as an isolated document, but by appraising its significance in the context of the body of law of which it is a part. In other words, Congress undoubtedly referred to existing law but the existing law is a living growing body of principles derived not only from the *National Life* and *Gehner*

cases but also from the other precedents discussed in Point I. Judged by existing law in that most meaningful sense, the apportionment formula does not impose a tax "on" interest from State bonds.

There is nothing to the contrary in *Helvering* v. *Griffiths,* 318 U.S. 371, where the Court held that the Internal Revenue Act of 1936 did not invite reconsideration of *Eisner* v. *Macomber,* 252 U.S. 189, even though the statute taxed all "dividends" with the proviso that a stock dividend was not to "be treated as a dividend to the extent that it does not constitute income to the shareholder within the meaning of the Sixteenth Amendment." 53 Stat. 47. The question was whether the quoted provision intended to incorporate the "existing constitutional law" or imposed a tax which was condemned by *Eisner* v. *Macomber* but which might be found constitutional upon reconsideration of that decision. The background of the provision was this: After the decision in *Eisner* v. *Macomber,* Congress, supposing the decision to imply that no stock dividends were taxable (even though the case involved only a common-on-common dividend), had itself excluded all stock dividends from taxable income. Later decisions, in different contexts, showed that *Eisner* v. *Macomber* should not be read so broadly. The primary purpose of the new provision in the Revenue Act of 1936 was to discard the exclusion and include in taxable income all the kinds of stock dividends which, under the subsequent decisions, were distinguishable from the common-on-common dividends involved in *Eisner* v. *Macomber.* Admittedly, there was no thought at

the time that the actual holding in *Eisner* v. *Macomber* could be successfully challenged. It was only after two decisions in 1940 had still further undermined the theoretical basis of *Eisner* v. *Macomber* that the Treasury changed the regulations and asserted that the Revenue Act of 1936 required common-on-common dividends to be included in taxable income. When that question came before this Court, the Court held that the very general language of the 1936 Act, which admittedly had another purpose and could be given another effective meaning without reaching common-on-common dividends, was not sufficient to show an intent to tax the very dividends that *Eisner* v. *Macomber* had held cannot be taxed. 318 U.S. at 394.

The Life Insurance Company Income Tax Act of 1959 is wholly unlike the provision at issue in *Griffiths* because Congress, in the detailed definitions of "gain from operations" and "taxable investment income" in the 1959 Act, prescribed in explicit words the precise manner in which tax-exempt income is to be taken into account. It incorporates the existing body of constitutional law as an overriding standard, if inconsistent, only in a "caveat" authorizing an "adjustment." In *Griffiths*, there was nothing in the statute flatly inconsistent with Congress' not wanting to tax common-on-common dividends and the question was therefore whether it had in fact "wanted" to tax them. Here, the explicit statutory formula is directly inconsistent with the hypothesis that Congress did not want the tax to be increased because

of tax-exempt interest no matter what the appropriate apportionment, and the question is therefore not whether Congress "wanted" that result but only whether its specifically-affirmed objective is inconsistent with assumed constitutional limitations Congress wanted to respect. In *Griffiths,* the Treasury was seeking to overrule a leading constitutional precedent. Here, putting the question most favorably to respondent, we are arguing only that *National Life* and *Gehner* must be read together with such equally important cases as *Denman* v. *Slayton, Helvering* v. *Independent Life Ins. Co.,* and other cases in the body of constitutional law of which they were a part.

In short, the very words of the statute and the interrelationship between the exception and the provisions establishing the formula compel the conclusion that Congress intended an adjustment only if the formula that it specifically prescribed was inconsistent with constitutional standards for determining whether a tax is imposed upon State bonds.

B. THE LEGISLATIVE HISTORY SHOWS THAT THE FUNCTION OF THE EXCEPTION CLAUSE IS TO PROVIDE AN ADJUSTMENT ONLY IF THE STATUTORY FORMULA VIOLATES THE ASSUMED CONSTITUTIONAL PROHIBITION AGAINST A TAX ON INTEREST FROM STATE BONDS

As noted above, in every statute taxing insurance companies since 1921 Congress has recognized that additions to policyholders' reserves consist in part of (or are in part a cost of producing) tax-exempt income and, therefore, that to allow the reserve addition and the tax-exempt interest both to be deducted in full from the investment income would result in duplicating deductions. Under the Revenue Act of

1942, the duplication was sought to be eliminated by allowing a reserve deduction equal to a fixed percentage of each company's investment income but computing the percentage on an industry-wide basis under a formula which reduced the deduction in proportion to the extent that industry's investment income consisted of tax-exempt interest. See H. Rep. No. 2333, 77th Cong., 2d Sess., pp. 107–108; S. Rep. No. 1631, 77th Cong., 2d Sess., pp. 142–143. The major change made by the 1959 Act was that the industry-wide method of computing the reserve deduction was eliminated and each company was treated individually.

The House bill (H.R. 4245), like the 1942 Act, allowed a "deduction" for the reserve addition but required that the deduction be reduced in the proportion that the company's tax-exempt interest (and the excludible portions of two other types of income) bore to its total investment income. The House Ways and Means Committee explained (H. Rep. No. 34, 86th Cong., 1st Sess., p. 11):

> To prevent this double allowance with respect to these amounts, the bill makes a reduction in the policy and other contract liability deduction for the portion of this deduction attributable to these three types of excluded or deducted income. *This does not, however, impose any tax on the exempt interest,* on 30/52ds of partially tax-exempt interest, or 85 percent of dividends received from domestic corporations. [Emphasis supplied.]

As the italicized portion indicates, the House Committee determined to its own satisfaction that the House

bill did not impose a tax on exempt interest, notwithstanding that it reduced a deduction and thus increased the tax when a company received tax-exempt interest.

During the Senate Finance Committee hearings on the House bill, the effect of the formula for reducing the reserve deduction to reflect the pro rata portion attributable to tax-exempt interest and other exempt income was fully explored from every aspect and fully debated by Senators and witnesses. Three points merit emphasis. First, and most important, it was made overwhelmingly clear to the Committee members that a necessary result of the statute was a reduction of the reserve deduction and thus an increase in the company's tax when it received an increment in interest from State bonds. *Hearings on H.R. 4245 before the Senate Finance Committee, 86th Cong., 1st Sess.* (hereinafter *"Senate Hearings"*) pp. 45, 46, 187, 253–254, 266–267, 310–313, 405, 414–415, 516–518, 613–614, 694–695. Second, it was repeatedly emphasized that a formula which caused the tax to be increased with the receipt of tax-exempt interest would necessarily reduce the tax advantages of owning State bonds and thus reduce the companies' incentive to buy such bonds.[25] *Id.* at 187, 252, 254, 267, 310–313, 405, 414–

[25] There is, we should note, nothing mysterious about the effect of the 1959 Act on a company's incentive to buy tax-exempt bonds. A fully taxable taxpayer derives the greatest benefit from tax-exempt items of income. A charity, being wholly exempt from tax anyway, derives no benefit and has no reason to prefer tax-exempt bonds over industrial bonds. Under the 1959 Act, a life insurance company is taxed only on, say, 20% of its income and is thus in effect an 80% tax-

415, 613–614, 687–690; see also, 45–47, 121–122; *cf.* 252–266 (tax on dividends). There was disagreement as to the extent of the effect and as to the wisdom and fairness of the result, but none as to the reality of the effect on the investment decisions of insurers.

As to the correctness of these two factual matters there was neither question nor dispute. As to the third subject of discussion, the question of constitutionality, there was plainly disagreement. Senator Butler and a number of insurance industry witnesses, relying on this Court's decisions in *National Life* and *Gehner,* contended that any reduction in the reserve deduction necessarily resulted in a tax on interest from State bonds in conflict with their traditional constitutional immunity. *Senate Hearings,* pp. 43–44, 305–318, 407–408, 516–518, 613–614, 700–702. Mr. Lindsay, Assistant to the Secretary of the Treasury, agreed with the House Ways and Means Committee that the bill could not be characterized as imposing a tax on tax-exempt interest, inasmuch as it merely charged a fair share of the company's major investment cost against the tax-exempt interest it helped to produce. *Id.* at 43, 44–51, 59. Most members of the Finance Committee apparently agreed. See the statement of Senator Curtis, quoted below (p. 68), who was chosen to explain the Committee bill to the Senate, and the statements of Senator Byrd, Chairman of the

---

exempt taxpayer. Being taxable on only 20% of its income anyway, it derives correspondingly less benefit from shifting some of its income from taxable to tax-exempt sources, and thus has less incentive to buy State bonds than would a fully taxable entity.

763-293—65——6

Committee, at 105 Cong. Rec. 8401 and 10400. The representatives of the States and their subdivisions wavered between the two positions, although they fully understood the tax and economic consequences of the House bill. *Senate Hearings,* pp. 121–122, 122–123, 699–700.

Perhaps most important for an understanding of the origin and purpose of the "exception" clauses was the disagreement between Senator Butler and Mr. Lindsay as to the proper method of resolving their dispute as to the constitutionality of the bill. Mr. Lindsay stated, "I feel that we should determine with the best advice we can, as to whether or not we today think such a provision is unconstitutional, and if we believe it is not, and if we believe the provision is right, we ought to include it in the bill," although the "question might very well be litigated." *Id.* at 43–44. Senator Butler apparently thought that the Treasury's arguments that the bill did not tax interest from State bonds were disingenuous. In a supplemental memorandum filed with the Committee he asked (*id.* at 702):

> What, then, is the Treasury Department's real purpose in proposing this formula? The answer is readily apparent. Stated simply, the Treasury wants to "buy" a lawsuit. If Congress can be persuaded to approve this formula, then hopefully some insurance company will then be tempted to contest the levy on constitutional grounds. The Treasury has been waiting for this opportunity for years. The arguments are prepared. All that is needed is the legal controversy which will lead to Su-

preme Court review of the *National Life* and *Missouri* v. *Gehner* cases.

The Treasury seems convinced that the Supreme Court in such a case would not only uphold this partial tax on tax-exempt bonds held by life insurance companies, but more particularly, would strike down the whole tax-exempt doctrine by reversing these previous decisions. I view in the gravest terms the Treasury Department's resort to this circuitous route to achieve what, in effect, amounts to a constitutional amendment, especially in a matter so important to our Nation's basic structure. Certainly, in a matter of this kind, the consent of Congress on the direct issue involved and ratification by the States would appear essential.

Following the hearings, the Senate Finance Committee recommended two changes in the House bill: (1) the reformulation of the provisions to account for the addition to the reserves by an "exclusion" of the "policyholders' share" of the income rather than by a "deduction" and (2) the addition of the "exception" clause. The substance of the House taxing formula was maintained; the Senate provisions dividing each item of income between the excluded "policyholders' share" and the "company's share" produced mathematical and economic results substantially the same as those produced by the House provisions reducing the reserve "deduction" in proportion to the exempt character of the company's income.

As explained in the Committee report and by the Committee spokesman on the floor (Senator Curtis), a primary purpose of the division of investment income

between the "policyholders' share" and the "company's share" was to state, in the clearest form possible, the Committee's view as to why tax-exempt interest should be considered in determining the amount of the exemption for the reserve for policyholders and why the result was not to tax tax-exempt interest. Senator Curtis said that the problem of accommodating the exemptions for the policyholders' reserves and interest from State bonds while not taxing tax-exempt interest was "a matter which has deeply concerned your committees" (105 Cong. Rec. 8429):

> * * *. The bill meets that problem most accurately and fairly. It provides for a division of all items of investment income—referred to in the bill as "investment yield"—into what are called the "policyholder's share" and the "life insurance company's share." The "policyholder's share" * * * is exempt from tax. * * * [A]ll items of tax-exempt income and credits are appropriately divided between the part of the investment income that is to be subjected to tax and the part that is not; and a full, complete deduction is allowed, in computing the net taxable portion, for all tax-exempt interest—and credits—attributable to the taxable portion of the investment income.

The Finance Committee Report is equally explicit in justifying the Committee's view that its treatment did not result in imposing a tax on tax-exempt interest. After explaining how the House bill reduced the reserve deduction to reflect tax-exempt income, it stated (S. Rep. No. 291, 86th Cong., 1st Sess., p. 6):

> Your committee believes that the division of income and expense items between the policyholders and the insurance company, with only the latter being taken into account for tax purposes, is a much better concept to follow. It also makes it clear that items which are properly exempt or deductible, such as tax-exempt State and municipal bond interest, partially tax-exempt Federal bond interest, and 85 percent of intercorporate dividends received, are properly divided between the policyholders and the life insurance company and that as far as the latter is concerned, namely, the only portion included in the tax base, full allowance is made for these items.

Simultaneously the "exception" clause was added. The Senate Report merely paraphrases the provisions without explanation. The floor debates in the Senate and House of Representatives are somewhat more instructive. Two closely related points emerge. First, there was absolutely no suggestion that the "exception" clause was to be an integral and generally operative part of the taxing formulae; the operation of the statute was always described without them. Second, the "exception" clause was rather plainly intended to come into play only if Congress had been mistaken in its judgment that the general taxing formula did not tax exempt interest. Thus, when asked if it was correct that "county and municipal bonds will not be taxed under the bill," Senator Byrd, Chairman of the Senate Finance Committee, responded (105 Cong. Rec. 10400): "That is my construction. There is a proviso that if by any chance

under the bill they should be taxed, necessary steps will be taken to refund the tax." He had earlier explained (105 Cong. Rec. 8401):

> In providing the formula I have described to the Senate it was the intention of the committee not to impose any tax on tax-exempt interest. The Treasury has assured the committee that this formula does not impose any tax on tax-exempt interest. The bill adds a proviso to the effect that if the formula I have described does result in the imposition of tax on this item, the formula is to be adjusted so that it does not do so.

Representative Mills, Chairman of the House Ways and Means Committee, expressed a similar understanding that the statutory formula imposed no tax on constitutionally exempt interest and that the exception provisions merely provided the reassurance of a judicial check of the correctness of this conclusion (105 Cong. Rec. 10412):

> As agreed to by the conferees, the final version of H.R. 4245 extensively rewrites the provisions of the House bill dealing with tax-exempt interest and dividends received, including the addition of a proviso to the effect that if in any particular case the formula under the bill does not provide the proper treatment of these items, appropriate adjustment will be made. It is my belief that the appropriate deduction was allowed by the House bill and that these provisions of the final bill, which closely follow the Senate amendment, make no change of substance.

In the light of the foregoing history, it cannot seriously be contended that Congress did not "understand" the taxing formula or was unaware that its effect would be to require a company with tax-exempt interest to pay a higher tax than it would have had to pay had it not received that interest. Since it is self-evident that a reduced deduction means a higher tax, the effect of the House bill—which in terms reduced the reserve "deduction" if the company had tax-exempt interest—could not have been mistaken by anyone. Moreover, that obvious fact of arithmetic (and the corollary that, the tax advantages of tax-exempt bonds being reduced, the incentive of life insurance companies to buy them would be reduced) was repeatedly called to the attention of the Senate Finance Committee during its hearings on the bill (see pp. 64–65, *supra*). The identical effect of the Senate's revision of the bill—which treated a part of the tax-exempt interest as having been "absorbed" by the reserve exclusion and therefore reduced the company's further deduction for tax-exempt interest—was, if anything, even more obvious, and in any event it was expressly acknowledged by all that the Senate's bill produced results mathematically identical to those of the House bill (see Chairman Mills' comment on the bill as agreed to in conference, p. 70, *supra*).

The history in fact shows that Congress was more than merely *aware* that a company with tax-exempt interest would, under the Act, have to pay a higher tax than if it had not received the interest. It shows that that was precisely the result that Congress *wanted* and the only reason why it adopted the formula in

the first place. The only system of taxing life insurance companies under which the tax paid by a company with tax-exempt interest is no higher than if the company had not received the interest is one in which (1) a deduction or exclusion is allowed for the full amount of the tax-exempt interest and (2) a further deduction or exclusion is allowed for the full amount of the addition to the reserve, wholly ignoring the fact that a part of the income produced by the investment of the reserve funds (or from which the addition to the reserve is made) is itself tax-exempt. That, however, was the very system which the Ways and Means Committee described as permitting a "double allowance" (p. 63, *supra*) and which Congress has persistently sought, both in the 1942 Act and the 1959 Act, to replace with a more equitable formula which takes account of the fact that the tax-exempt income should bear (or contribute) its fair share of the addition to the reserve. The proration formula was adopted, therefore, precisely in order to impose a higher (*i.e.*, more equitable) tax on life insurance companies than they would have to pay if they were treated as not having received their tax-exempt interest at all (*i.e.*, if they were given a "double allowance"). To say that Congress did not "know" that result would be produced by the formula adopted, or did not "want" that result to be produced, is to deny the very reason for the development of the formula and to say that Congress has been unconscious of what the whole fight has been about over the many years that it has struggled to find an equitable basis for the taxation of life insurance companies.

While there was no issue in the hearings and debates about what the bill did—the mathematical results were plain and understood by everyone—there was a very substantial question about whether it was desirable as a matter of social and economic policy. On the one hand, it was argued by witnesses opposing the enactment of the bill that it was undesirable to tax insurance companies in a way that would (by reducing the advantages to them of tax-exempt interest) reduce their incentive to buy State bonds and thereby, perhaps, force State and local governments to pay a higher interest rate in order to sell their bonds (see, *e.g., Senate Hearings,* pp. 121–122). It was argued in favor of the bill, on the other hand, that, without the allocation provisions, life insurance companies could virtually eliminate any income tax by putting only a fraction of their investments into State bonds and corporate stocks (*id.* at 45–47). The nature of the argument is illustrated by the prolonged exchange between Senator Kerr and Mr. Beers, the president of Aetna Life Insurance Company, about the desirability of the treatment accorded corporate dividends (*id.* at 248, 260–266). Since corporations are generally allowed to exclude 85% of any dividends received from other corporations from their income (§ 243), such dividends represent, in effect, partially tax-exempt income. The bill (like the Act) accordingly treated the exempt portion of dividends in the same manner as it did interest from State bonds. Mr. Beers argued that, as a result of the bill's allocation of a pro rata part of the dividends to the reserve, a typical insurance company's taxable income would

increase by 60% of any additional corporate dividends received rather than by 15%, as in the case of ordinary corporations. Senator Kerr did not dispute Mr. Beers' arithmetic, but vigorously challenged his characterization of the result. A more accurate description of what happens, he argued, was that, while other corporations pay a tax on 15% of the total dividends they receive, a typical life insurance company receiving a total of $140,000 in dividends would pay a tax on only $6,000, or only on about 4% of the total dividends received. In short, there was no lack of understanding over what the bill did; the only question was whether what it did was desirable.

Congress, having considered all the arguments pro and con over the desirability of the effects the bill admittedly would have, decided on balance that the bill provided an equitable basis for the taxation of life insurance companies and that any adverse effects the bill might have on the market for State bonds were not great enough to warrant giving to insurance companies the unfair advantage of duplicating deductions or exclusions. Life insurance companies holding more than 70% of the industry's assets agreed that the bill provided an equitable method of taxation and should be adopted, saying (105 Cong. Rec. 8402): "The proration method of treating tax-free interest and the dividends received on corporate stock recommended by your committee is similar in principle to the one included in all laws since 1942 and we urge that it be adopted." The definitions of "gain from operations" and "taxable investment income" were enacted into law, in short, not because Congress

did not understand what they said or how they would operate, but because of a specific policy judgment, concurred in by the larger part of the insurance industry, that life insurance companies *should* be taxed in the way prescribed by those definitions.

Having formulated the definitions specifically in order to produce the results they do produce, and having decided as a matter of policy that that was the manner in which life insurance companies ought to be taxed, Congress was faced with one final issue: was the bill, desirable as it was, consistent with the general "constitutional" immunity of State bonds from federal tax? The Ways and Means Committee thought it plain that the bill did not impose a tax "on" tax-exempt interest (p. 63, *supra*). In the Senate Hearings, however, the constitutionality of the bill was vigorously disputed, with Senator Butler and several industry witnesses arguing that the bill was unconstitutional under *National Life* and *Gehner* and representatives of the Treasury arguing that it was constitutional (see p. 65, *supra*). The majority of the Senate committee not only agreed with the House and the Treasury but reformulated the definitions (to provide for a division of all the items of income pro rata between an excluded "policyholders' share" and the "company's share") in order to make it unmistakably clear that the tax-exempt interest was only being fairly allocated and was not itself being taxed (see Senator Curtis' statement, p. 68, *supra*).

At the same time that it revised the definitions to make it more clear that they did not impose a tax on tax-exempt interest, the Senate committee also added

the "exception" clause authorizing an adjustment to the tax if the Act should otherwise be held to result in "the imposition of tax on" interest from State bonds. Inasmuch as the committees of both Houses had satisfied themselves that the bill as written did not tax tax-exempt interest, the "exception" clause might well have been omitted. To be sure, the courts might disagree with the committees' judgment, but in that event the courts presumably would not need statutory authority to adjust the tax; the Court in *National Life* had drawn its warrant from the Constitution, not from Congress. But the fear expressed by Senator Butler was a reason for adding an express statutory caveat—namely, that the Treasury might make litigation under the Act the occasion for arguing not merely that the Act does not in fact tax interest from State bonds, but also that the whole doctrine of immunity should be overruled and the Court should hold that there is no constitutional barrier to taxing such interest (pp. 66–67, *supra*). The "exception" clause avoided that danger by providing a statutory adjustment should the Act be held to tax tax-exempt interest, thereby forestalling any challenge to the immunity of State bonds as a constitutional doctrine. That provides a fully satisfactory explanation of the "exception" clause and there is nothing to suggest that Congress intended anything more.

Since the Act does not impose a tax upon tax-exempt interest under the established constitutional doctrine, the exemption clause remains inoperative and the statutory formula must be given effect.

CONCLUSION

For the reasons stated, the judgment below should be reversed.

Respectfully submitted.

ARCHIBALD COX,
Solicitor General.

LOUIS F. OBERDORFER,
Assistant Attorney General.

WAYNE G. BARNETT,
PHILIP B. HEYMANN,
Assistants to the Solicitor General.

FEBRUARY 1965.

APPENDIX A

COMPUTATION OF GAIN FROM OPERATIONS

1. Assume that a life insurance company has a total investment yield of $1,000,000, including $100,000 in interest from State bonds, and that the amount it is required under State law to add to its reserves for policyholder claims (the "reserve addition") is $800,000. The following schedule shows how the company's "gain from operations" is computed under the statutory formula (Case 1) and how the court of appeals' decision requires it to be computed (*i.e.*, by treating the company as though it had not received the interest from State bonds) (Case 2).

Schedule A

	Case 1 (tax-exempt interest included)	Case 2 (tax-exempt interest excluded)
1. Taxable income	$900,000	$900,000
2. Tax-exempt interest	100,000	0
3. Total investment yield (line 1+line 2)	1,000,000	900,000
4. Reserve addition	800,000	800,000
5. Company's share of investment yield (line 3—line 4)	200,000	100,000
6. Company's percentage share (line 5÷line 3)	20%	11.1%
7. Company's share of tax-exempt interest (line 6×line 2)	20,000	0
8. Net amount included in gain from operations (line 5—line 7)	$180,000	$100,000

2. Assuming the same facts, the following schedule shows how gain from operations would be computed if the interest from State bonds were first excluded in full and a "deduction" were then allowed for the reserve addition in proportion to the extent that the investment income consisted of taxable items:

Schedule B

1. Total investment yield	$1,000,000	
2. Tax-exempt interest	$100,000	
3. Taxable income (line 1—line 2)		$900,000
4. Ratio of taxable income to total investment yield (line 3÷line 1)—(per cent)	90	
5. Reserve addition	$800,000	
6. Deductible portion of reserve addition (line 4×line 5)		$720,000
7. Net amount includible in gain from operations (line 3—line 6)		$180,000

3. The computation of gain from operations is also depicted graphically on the fold-out chart inside the back cover of this brief. The entire square represents the total investment yield of $1,000,000. Vertically, the yield is divided according to its source, with the tax-exempt interest ($100,000) being represented by the diagonally-lined area and the taxable income ($900,000) being represented by the remaining (unlined) area. Horizontally, the yield is divided according to its distribution, with the "policyholders' share" ($800,000, equal to the addition to the reserve) being represented by the gray (*i.e.*, shaded) area and the "company's share" ($200,000, the amount remaining) being represented by the white (*i.e.*, unshaded) area. The result of the two divisions is to show the "policyholders' share" and the "company's share" of the yield as each consisting of a pro rata share of each kind of income: the unlined gray area represents the policyholders' share of the taxable income ($720,000) while the diagonally-lined gray area represents their share of the tax-exempt interest ($80,000); the unlined white area represents the company's share of the taxable income ($180,000) while the diagonally-lined white area represents its share of the tax-exempt interest ($20,000). The computation prescribed by the Act is thus graphically illustrated by the chart: from the total

yield ($1,000,000), there is subtracted first the entire gray area ($800,000) and then the diagonally-lined white area ($20,000), leaving only the unlined white area ($180,000) as the amount on which the company is taxed.

The chart can also be used to illustrate the alternative method of computation set out in Schedule B, *supra*. The gray area represents the total reserve addition ($800,000). If the reserve addition is treated as a "cost" of producing the investment income and is allocated in proportion to the kinds of income it produces, the unlined gray area ($720,000) represents the portion of the cost attributable to the production of the taxable income and the diagonally-lined gray area ($80,000) represents the portion attributable to the production of the tax-exempt interest. The alternative method of computation (in which there is subtracted first the full amount of the tax-exempt interest and then the portion of the reserve-addition "cost" allocable to the taxable income) may therefore be illustrated on the chart as follows: from the total yield ($1,000,000), there is subtracted first the entire diagonally-lined area ($100,000) and then the unlined gray area ($720,000), again leaving only the unlined white area ($180,000) as the amount on which the company is taxed.

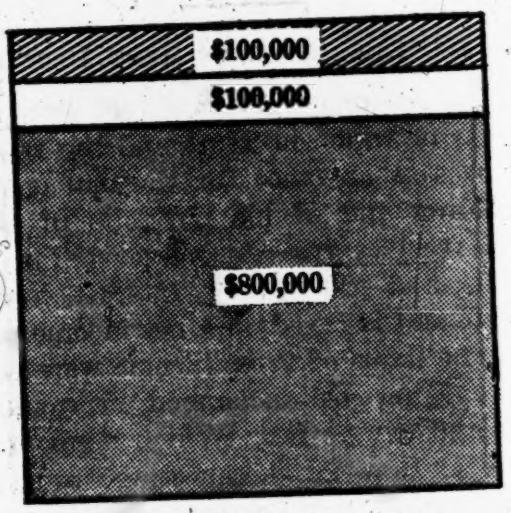
The chart thus makes apparent the equivalence of the two methods of computation. Although the order of subtraction is somewhat different, they subtract the same areas and are but alternative methods designed to accomplish the same thing: to avoid subtracting the diagonally-lined gray area ($80,000) twice, once as part of the diagonally-lined area (tax-exempt interest) and once as part of the gray area (addition to the reserve).

763-293—65——7

The chart also permits a ready visualization of the effect of changes in the investment yield. A change in the total amount of the investment yield would move the top line up or down; a change in the composition of the yield would move the verticle line separating the diagonally-lined area and the unlined area to the right or to the left. A *substitution* of tax-exempt interest for taxable income would thus simply move the vertical line to the left. An *incremental* receipt of tax-exempt interest, however, would both move the top line up (increasing the total yield) and move the vertical line to the left (changing the relative composition). The gray area ($800,000) is not affected by movements of the top line of the chart, reflecting the fact that the required addition to the reserve is a constant, unaffected by changes in the total investment yield. The extent to which the gray area is diagonally-lined or unlined is, however, affected by movements of the vertical line, reflecting the fact that the "policyholders' share" of the income is made up of a pro rata share of each kind of income (or that the reserve addition, seen as a cost, is chargeable proportionately to all the kinds of income produced by the investment of the reserve funds).

The method of computation urged by respondent and adopted by the court below can be visualized on

the chart by turning the vertical divisions to the horizontal, with the diagonally-lined area being superimposed on the top half of the white area, so that the chart would look like this:



The computation would then be as follows: from the total investment yield ($1,000,000), there is subtracted first the entire diagonally-lined area at the top of the chart ($100,000) and then the entire gray area at the bottom of the chart ($800,000), leaving only the unlined half of the white area ($100,000) as the amount on which the company is taxed.

APPENDIX B

EXAMPLES OF APPORTIONMENT PROBLEMS

Example 1. Assume that a taxpayer owns a building three-fourths of which he rents and the remainder of which he uses as an office for the management both of the building and of his portfolio of stocks and bonds. He receives gross income of $50 in rents, $30 in dividends, and $20 in bond interest, has expenses totalling $80, and is taxed on a net income of $20. If any one of the items of gross income were eliminated, leaving everything else unchanged, he would have no net income and pay no tax. Which items of gross income is the tax "on"? The question can be answered only by first making a reasonable allocation of the expenses among the several items of gross income. The following table illustrates how that might be done:

Table I

Income and Expenses	Unapportioned	Apportioned		
		Rents	Dividends	Interest
Gross Income	100	50	30	20
Expenses:				
Building expenses (apportioned by rental value of space and then by income from investments)	40	30	6	4
Office expenses (by time spent)	20	12	5	3
Interest paid on borrowings for investment (by value of investments)	10	--------	5	5
Safety deposit box (by bulk of documents)	5	--------	2	3
Investment counsel (by use)	5	--------	5	--------
Total expenses	80	42	23	15
Net income	20	8	7	5

Assuming the reasonableness of the allocations, it is apparent that the bond interest contributes only $5 to the net income. If the bonds were State bonds the interest on which was constitutionally immune from tax, it would be necessary, in order not to tax that interest, to reduce the net income only by $5, not by the full amount of the interest ($20).

Example 2. The following computation compares the depreciation allowable for an automobile if it is used solely for business purposes (Case 1) with that allowable if it is also used for personal purposes (Case 2). The fact that in Case 2 the allowable deduction is decreased, and the taxable income therefore increased, solely because of the use of the automobile for personal purposes does not mean that a tax is being imposed "on" the personal use itself.

Table II

	Case 1	Case 2
1. Cost of automobile	$2,000	$2,000
2. Depreciation rate	25%	25%
3. Depreciation (line 2×line 1)	$500	$500
4. Business use (in miles)	12,000	12,000
5. Personal use (in miles)	0	8,000
6. Percentage use in business (line 4÷(line 4+line 5))	100%	60%
7. Deductible depreciation (line 6×line 3)	$500	$300

Example 3. Assume that a trust instrument requires the trustee to pay *A* $80 a year out of the trust's income (or, if necessary, corpus) and to pay the balance of the income, if any, to *B*. In the first year of the trust, the trust receives only $80 of income, consisting of $40 in capital gains and $40 in dividends. As the following table illustrates, all of the income would be distributed to *A* and *A*'s receipts would be deemed to consist of all of each item of income:

Table III

Kinds of Income	Receipts	Distributions	
		To *A*	To *B*
Total income	$80	$80 (100%)	0
Items:			
Capital gains	40	40	0
Dividends	40	40	0
Taxable income	80	80	0

In the second year of the trust, the trust receives an additional $20 of income in the form of interest from State bonds, making the total income $100. Under the trust instrument, $80 would be distributed to *A* and the balance, $20, would be distributed to *B*. For tax purposes the distributions to each would be deemed to consist of a pro rata share of each item of income (§ 662), as shown by the following table:

Table IV

Kinds of income	Receipts	Distributions	
		To *A*	To *B*
Total income	$100	$80 (80%)	$20 (20%)
Items:			
Capital gains	40	32	8
Dividends	40	32	8
Bond interest (exempt)	(20)	(16)	(4)
Taxable income	80	64	16

A comparison of the two tables shows that the trust's receipt of an additional $20 of *tax-exempt* interest causes *B* to have *taxable* income of $16, notwithstanding that he would have had no taxable income and owed no tax if the trust had not received the interest (as was the case in the first year). And if *A* were a tax-exempt charity, the result would be that no tax at all would be due in the first year but a tax would be due on $16 of income in the second year, solely because of the trust's receipt of tax-exempt interest.

APPENDIX C

Internal Revenue Code of 1954, as amended by Sec. 2, Life Insurance Company Income Tax Act of 1959, 73 Stat. 112, 26 U.S.C. 1958 ed., Supp. V.

SEC. 103. INTEREST ON CERTAIN GOVERNMENTAL OBLIGATIONS.

(a) *General Rule.*—Gross income does not include interest on—

(1) the obligations of a State, a Territory, or a possession of the United States, or any political subdivision of any of the foregoing, or of the District of Columbia;

* * * * *

SEC. 801. DEFINITION OF LIFE INSURANCE COMPANY.

* * * * *

(b) *Life insurance reserves defined.*

(1) *In general.*

For purposes of this part, the term "life insurance reserves" means amounts—

(A) which are computed or estimated on the basis of recognized mortality or morbidity tables and assumed rates of interest, and

(B) which are set aside to mature or liquidate, either by payment or reinsurance, future unaccrued claims arising from life insurance, annuity, and noncancellable health and accident insurance contracts (including life insurance or annuity contracts combined with noncancellable health and accident insurance) involving, at the time with respect to which the reserve is computed, life, health, or accident contingencies.

(2) *Reserves must be required by law.*

* * * * * *

in addition to the requirements set forth in paragraph (1), life insurance reserves must be required by law.

* * * * *

SEC. 802. TAX IMPOSED.

(a) *Tax Imposed.*—

(1) *In general.*—A tax is hereby imposed for each taxable year beginning after December 31, 1957, on the life insurance company taxable income of every life insurance company. Such tax shall consist of—

(A) a normal tax on such income computed at the rate provided by section 11(b), and

(B) a surtax, on so much of such income as exceeds $25,000, computed at the rate provided by section 11(c).

* * * * *

(b) *Life Insurance Company Taxable Income Defined.*—For purposes of this part, the term "life insurance company taxable income" means the sum of—

(1) the taxable investment income (as defined in section 804) or, if smaller, the gain from operations (as defined in section 809),

(2) if the gain from operations exceeds the taxable investment income, an amount equal to 50 percent of such excess, plus

(3) the amount subtracted from the policyholders' surplus account for the taxable year, as determined under section 815.

* * * * *

SEC. 804. TAXABLE INVESTMENT INCOME.

(a) *In general.*—

(1) *Exclusion of policyholders' share of investment yield.*—The policyholders' share of each and every item of investment yield (including tax-exempt interest, partially tax-exempt interest, and dividends received) of any life insurance company shall not be included in taxable investment income. For purposes of the preceding sentence, the policyholders' share of any item shall be that percentage obtained by dividing the policy and other contract liability requirements by the investment yield; except that if the policy and other contract liability requirements exceed the investment yield, then the policyholders' share of any item shall be 100 percent.

(2) *Taxable investment income defined.*—For purposes of this part, the taxable investment income for any taxable year shall be an amount (not less than zero) equal to the sum of the life insurance company's share of each and every item of investment yield (including tax-exempt interest, partially tax-exempt interest, and dividends received), reduced by—

(A) the sum of—

(i) the life insurance company's share of interest which under section 103 is excluded from gross income,

(ii) the deduction for partially tax-exempt interest provided by section 242 (as modified by paragraph (3)) computed with respect to the life insurance company's share of such interest, and

(iii) the deductions for dividends received provided by sections 243, 244, and 245 (as modified by paragraph (5)) computed with respect to the life insurance company's share of the dividends received; and

(B) the small business deduction provided by paragraph (4).

For purposes of the preceding sentence, the life insurance company's share of any item shall be that percentage which, when added to the percentage obtained under the second sentence of paragraph (1), equal 100 percent.

* * * * *

(6) *Exception.*—If it is established in any case that the application of the definition of taxable investment income contained in paragraph (2) results in the imposition of tax on—

(A) any interest which under section 103 is excluded from gross income,

(B) any amount of interest which under section 242 (as modified by paragraph (3)) is allowable as a deduction, or

(C) any amount of dividends received which under sections 243, 244, and 245 (as modified by paragraph (5)) is allowable as a deduction,

adjustment shall be made to the extent necessary to prevent such imposition.

(b) *Gross Investment Income.*—For purposes of this part, the term "gross investment income" means the sum of the following:

(1) *Interest, etc.*—The gross amount of income from—

(A) interest, dividends, rents, and royalties,

* * * * *

(c) *Investment Yield Defined.*—For purposes of this part, the term "investment yield" means the gross investment income less the following deductions—

(1) *Investment expenses.*—Investment expenses for the taxable year. * * *

* * * * * *

SEC. 805. POLICY AND OTHER CONTRACT LIABILITY REQUIREMENTS.

(a) *In General.*—For purposes of this part, the term "policy and other contract liability requirements" means, for any taxable year, the sum of—

(1) the adjusted life insurance reserves, multiplied by the adjusted reserves rate,

(2) the mean of the pension plan reserves at the beginning and end of the taxable year, multiplied by the current earnings rate, and

(3) the interest paid.

(b) *Adjusted Reserves Rate and Earnings Rates.*—

(1) *Adjusted reserves rate.*—For purposes of this part, the adjusted reserves rate for any taxable year is the average earnings rate or, if lower, the current earnings rate.

(2) *Current earnings rate.*—For purposes of this part, the current earnings rate for any taxable year is the amount determined by dividing—

(A) the taxpayer's investment yield for such taxable year, by

(B) the mean of the taxpayer's assets at the beginning and end of the taxable year.

(3) *Average earnings rate.*—

(A) *In general.*—For purposes of this part, the average earnings rate for any taxable year is the average of the current earnings rates for such taxable year and for each of the 4 taxable years immediately preceding such taxable year (excluding any of such 4 taxable years for which the taxpayer was not an insurance company).

* * * * * *

(4) *Assets.*—For purposes of this part, the term "assets" means all assets of the company (including nonadmitted assets), other than real and personal property (excluding money) used by it in carrying on an insurance trade or business. * * *

* * * * *

(c) *Adjusted Life Insurance Reserves.*—

(1) *Adjusted life insurance reserves defined.*—For purposes of this part, the term "adjusted life insurance reserves" means—

(A) the mean of the life insurance reserves (as defined in section 801(b)), other than pension plan reserves, at the beginning and end of the taxable year, multiplied by

(B) that percentage which equals 100 percent—

(i) increased by that percentage which is 10 times the average rate of interest assumed by the taxpayer in calculating such reserves, and

(ii) reduced by that percentage which is 10 times the adjusted reserves rates.

(2) *Average interest rate assumed.*—For purposes of this part, the average rate of interest assumed in calculating reserves shall be computed—

(A) by multiplying each assumed rate of interest by the means of the amounts of such reserves computed at that rate at the beginning and end of the taxable year, and

(B) by dividing (i) the sum of the products ascertained under subparagraph (A), by (ii) the mean of the total of such reserves at the beginning and end of the taxable year.

* * * * *

SEC. 809. IN GENERAL.

(a) *Exclusion of Share of Investment Yield Set Aside for Policyholders.*—

(1) *Amount.*—The share of each and every item of investment yield (including tax-exempt interest, partially tax-exempt interest, and dividends received) of any life insurance company set aside for policyholders shall not be included in gain or loss from operations. For purposes of the preceding sentence, the share of any item set aside for policyholders shall be that percentage obtained by dividing the required interest by the investment yield; except that if the required interest exceeds the investment yield, then the share of any items set aside for policyholders shall be 100 percent.

(2) *Required interest.*—For purposes of this part, the required interest for any taxable year is the sum of the products obtained by multiplying—

(A) each rate of interest required, or assumed by the taxpayer, in calculating the reserves described in section 810(c), by

(B) the means of the amount of such reserves computed at that rate at the beginning and end of the taxable year.

(b) *Gain and Loss From Operations.*—

(1) *Gain from operations defined.*—For purposes of this part, the term "gain from operations" means the amount by which the sum of the following exceeds the deductions provided by subsection (d):

(A) the life insurance company's share of each and every item of investment yield (including tax-exempt interest, partially tax-exempt interest, and dividends received); and

(B) the sum of the items referred to in subsection (c).

* * * * * * *

(3) *Life insurance company's share.*—For purposes of this subpart, the life insurance company's share of any item shall be that percentage which, when added to the percentage obtained under the second sentence of subsection (a)(1), equals 100 percent.

(4) *Exception.*—If it is established in any case that the application of the definition of gain from operations contained in paragraph (1) results in the imposition of tax on—

(A) any interest which under section 103 is excluded from gross income,

(B) any amount of interest which under section 242 (as modified by section 804(a)(3)) is allowable as a deduction, or

(C) any amount of dividends received which under sections 243, 244, and 245 (as modified by subsection (d)(8)(B) is allowable as a deduction,

adjustment shall be made to the extent necessary to prevent such imposition.

* * * * *

(d) *Deductions.*—For purposes of subsections (b)(1) and (2), there shall be allowed the following deductions:

* * * * *

(8) *Tax-exempt interest, dividends, etc.*—

(A) *Life insurance company's share.*—Each of the following items:

(i) the life insurance company's share of interest which under section 103 is excluded from gross income,

(ii) the deduction for partially tax-exempt interest provided by section 242 (as modified by section 804(a)(3)) computed with respect to the life insurance company's share of such interest, and

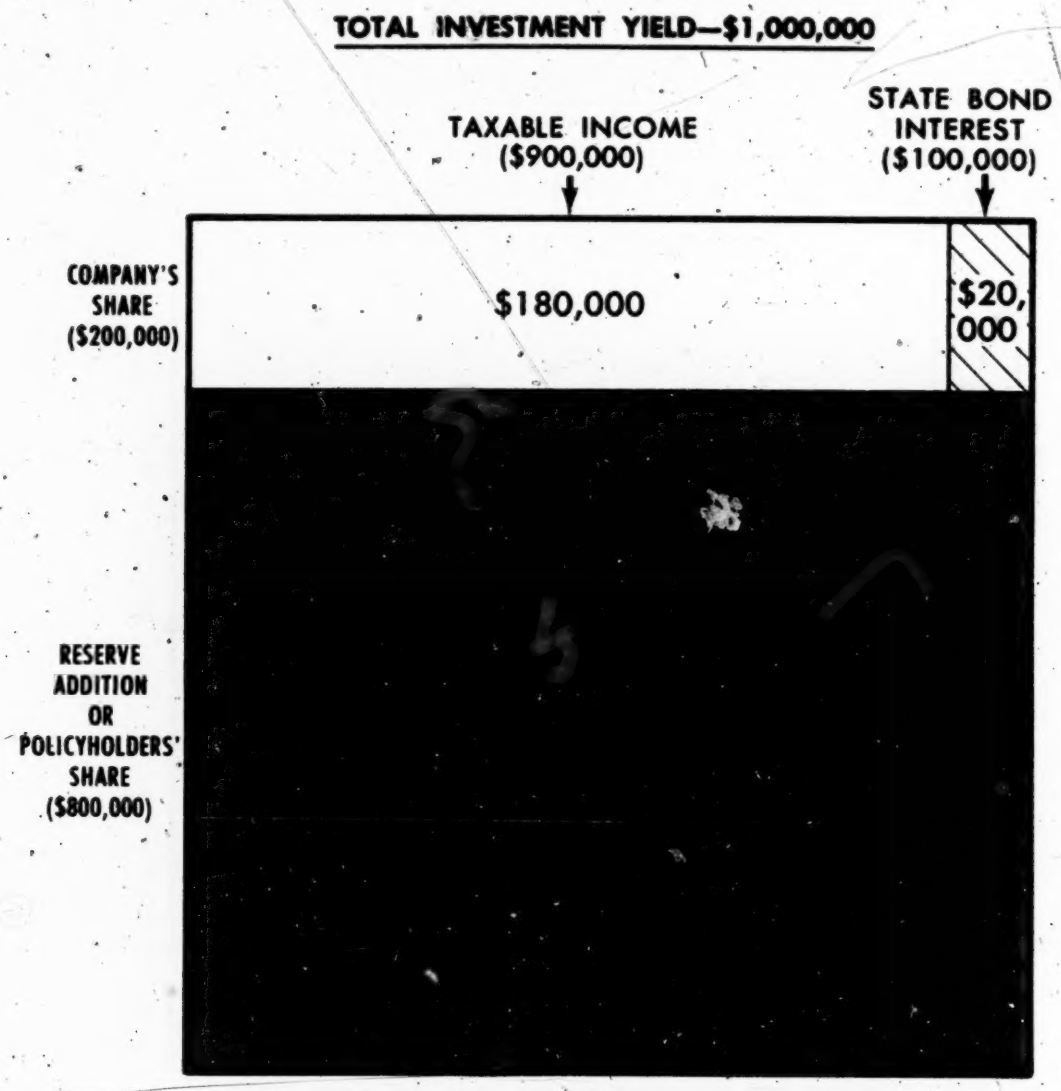
(iii) the deductions for dividends received provided by sections 243, 244, and 245 (as modified by subparagraph (B)) computed with respect to the life insurance company's share of the dividends received.

* * * * * *

U.S. GOVERNMENT PRINTING OFFICE: 1981

CHART SHOWING APPORTIONMENT OF INVESTMENT YIELD IN COMPUTATION OF GAIN FROM OPERATIONS

[Company with total investment yield of $1,000,000; interest from State bonds of $100,000; and a required addition to the policyholder reserves of $800,000.]



[For detailed explanation, see pp. 80–83, *supra*.]

LIBRARY
SUPREME COURT, U.S.

Office-Supreme Court, U.S.
FILED
MAR 17 1965
JOHN F. DAVIS, CLERK

IN THE

Supreme Court of the United States

October Term, 1964

No. 489

UNITED STATES OF AMERICA,

Petitioner,

v.

ATLAS LIFE INSURANCE COMPANY,

Respondent.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT

AMICI CURIAE BRIEF FOR STATE AND LOCAL GOVERNMENTS IN SUPPORT OF AFFIRMANCE

GRANT SAWYER, Governor of Nevada and Chairman of the *Governors' Conference*

LOUIS L. GOLDSTEIN, Comptroller of Maryland and Chairman of Committee on Taxation of State Bonds of the *National Association of State Auditors, Comptrollers and Treasurers*

JEROME CAVANAGH, Mayor of Detroit and Vice President of the *National League of Cities*

C. BEVERLY BRILEY, County Mayor of the Metropolitan District Government of Nashville—Davidson County, Tennessee and Immediate Past President of the *National Association of Counties*

ROBERT B. MATHIAS, County Counsel of Prince Georges County, Maryland and President of the *National Association of County Civil Attorneys*

C. D. WARD, General Counsel of the *National Association of Counties.*

MITCHELL WENDELL, Counsel to the *Council of State Governments*

JACK P. F. GREMILLION, Attorney General of Louisiana and President of the *National Association of Attorneys General*

JOHN J. O'CONNELL, Attorney General of Washington and Immediate Past President of the *National Association of Attorneys General*

JOHN J. GUNTHER, General Counsel of the *United States Conference of Mayors*

JOHN J. FLEMING, City Attorney of Milwaukee, Wisconsin and President of the *National Institute of Municipal Law Officers*

CHARLES S. REYNE, General Counsel of the *National Institute of Municipal Law Officers*

DANIEL B. GOLDBERG, General Solicitor of The Port of New York Authority, Counsel for the *Municipal Finance Officers Association* and Secretary of the *Conference on State Defense*

111 Eighth Avenue,
New York, N. Y. 10011.

Amici Curiae

With them on the brief:

CHARLES E. NORMAN,
City Attorney, Tulsa, Oklahoma.

MICHAEL S. ZARIN,
Attorney, The Port of New York Authority.

INDEX

	PAGE
STATEMENT	1
POINT I—The reasons for the congressional concern to preserve the exemption of state and local government bond interest	6
(1) The values to state and local government which Congress has chosen to protect	7
(2) The effect of relative federal and state revenue needs on the congressional objective	12
POINT II—The scope of the traditional immunity of state and local government bond interest which was protected by the Congress in the Exception provisions	17
(1) The Exceptions should be interpreted to avoid, not to raise grave constitutional questions	17
(2) The origin and scope of the traditional immunity—no taxpayer has ever been required to pay a higher income tax solely as a result of the receipt of state or local government bond interest	18
(3) Fairness forbids rather than requires the proration technique	23
(4) By citing cases in other fields Petitioner is venturing its prediction of the future of the immunity doctrine and not recognizing the doctrine's "traditional" and "established" scope as required by Congress	28
(5) Petitioner's theory cannot explain the portions of the Exceptions which do not relate to the traditional immunity doctrine	33

PAGE

(6) The Tenth Circuit's interpretation gives the language its normal meaning 34

POINT III—The legislative history of the Act shows that Congress intended the basic formula for taxing life insurance companies to be displaced and adjusted in the case of any taxpayer whose tax under the basic formula would be increased solely as a result of its receipt of state or local government bond interest 36

POINT IV—The necessity of giving meaning to the Exception provisions 48

CONCLUSION 54

CITATIONS

Cases:

Bryant v. *Commissioner*, 111 F. 2d 9 (1940) 7

In re *Coates*, 9 N. Y. 2d 242 (1961), app. dism. 368 U. S. 34 (1961) 17

Crowell v. *Benson*, 285 U. S. 22 (1932) 17

Denman v. *Slayton*, 282 U. S. 514 (1931) 26, 28

Faitoute Iron and Steel Co. v. *Asbury Park*, 316 U. S. 502 (1942) 9

Hale v. *Iowa State Board*, 302 U. S. 95 (1937) 21

Helvering v. *Gerhardt*, 304 U. S. 405 (1938) 21, 22, 30

Helvering v. *Griffiths*, 318 U. S. 371 (1943) 32

Helvering v. *Independent Life Insurance Co.*, 292 U. S. 371 (1934) 29

James v. *Dravo Contracting Co.*, 302 U. S. 134 (1937) 9, 30

PAGE

McCulloch v. *Maryland*, 4 Wheat. 316 (1819) 30
Missouri v. *Gehner*, 281 U. S. 313 (1930) 19, 21

National Life Ins. Co. v. *United States*, 277 U. S. 508 (1928) 5, 19, 20, 21, 24
New York v. *United States*, 326 U. S. 572 (1946) ..10, 30, 31

Pollock v. *Farmers' Loan & Trust Co.*, 158 U. S. 601 (1895) 19, 20, 21

Shamberg v. *Commissioner*, 3 T. C. 131 (1944), aff'd 144 F. 2d 998 (1944), cert. den. 323 U. S. 792 (1945) 6
Sinclair Refining Company v. *Atkinson*, 370 U. S. 195 (1962) 46, 52

United States v. *Menasche*, 348 U. S. 528 (1955) 48
United States v. *Moy*, 241 U. S. 394 (1916) 17
United States v. *Rumely*, 345 U. S. 41 (1953) 17

Statutes:

Internal Revenue Code of 1954, as amended:

Sec. 103 .....18, 19, 25
Sec. 265(2) 26, 27
Sec. 804(a)(6) 3, 18
Sec. 805(e), (f) 36
Sec. 809(b)(4) 18
Sec. 7852(a) 53

Revenue Act of 1913, 38 Stat. 114 19
Revenue Act of 1921, 42 Stat. 227 19
Revenue Act of 1942, 56 Stat. 870 ..... 22, 23
73 Stat. 622 24

Miscellaneous:

Annual Report of the Secretary of the Treasury for the Fiscal Year Ended June 30, 1963 ..... 13, 16
50 Cong. Rec. 508 19
83 Cong. Rec. 5183 8

PAGE

86 Cong. Rec. 18621 22
105 Cong. Rec. 8401 ..... 43, 48
105 Cong. Rec. 8402 ..... 43, 48
105 Cong. Rec. 10400 44
Conference Report No. 520, 86th Cong., 1st Sess. .. 44
The Constitutional Immunity for State and Municipal Securities—A Legal Defense of the Continued Integrity of the Fiscal Powers of the States 22
The Fiscal and Economic Aspects of the Taxation of Public Securities 22
General Counsel of the Treasury Department, letter to the Secretary of the Conference on State Defense, November 27, 1959 50
Hearings before the Special Committee pursuant to S. Res. 303 (75th Cong.), 1939..... 7
Hearings, 76th Cong., 1st Sess., on Proposed Legislation Relating to Tax-Exempt Securities 7
Hearings before the Senate Committee on Finance, Revenue Act of 1942 ..... 7, 10
Hearings before the House Committee on Ways and Means on the Revenue Revision of 1942 7
Hearings before House Committee on Ways and Means on the Revenue Revision of 1951 ..... 7, 10
Hearings before the Senate Committee on Finance, Revenue Act of 1942 10
Hearings before the Senate Finance Committee on H. R. 4245, 86th Cong., 1st Sess. 11, 12, 14, 27, 32, 37, 38, 39, 40, 41, 43
Heilbroner, R. L., *New York Times Magazine*, December 27, 1964 ..... 15, 16
Hill, J. S., *The National Underwriter*, March 6, 1965 12, 13, 50
H. R. 4245, 86th Cong., 1st Sess. 36
H. Report 1385, 73rd Cong., 2d Sess. 27
H. Res. 7835, 73rd Cong. 26

PAGE

Institute of Life Insurance, *1964 Life Insurance Fact Book* 13, 16, 50

Internal Revenue Service

Reg. § 1.804-2(f) 53
Reg. § 1.809-3(d) 53
Rev. Rul. 61-222, 1961-2 CB 58 25
Technical Information Release, December 1, 1961 ..... 26, 27

Loftus, J. A., "Fiscal Myth Exploded; State and Local Budgets, Not Federal, Are Soaring—And Will Do So in Future", *New York Times*, February 1, 1965 14

S. Report No. 558, 73rd Cong., 2d Sess. 26

S. Report 291, 86th Cong., 1st Sess. 49

S. Report No. 909, 86th Cong., 1st Sess. 24

U. S. Treasury Dept. Press Service Release No. 24-3, March 14, 1941 6

Ways and Means Committee press release dated February 8, 1954 10

IN THE

Supreme Court of the United States

OCTOBER TERM, 1964

No. 489

UNITED STATES OF AMERICA,
Petitioner,

v.

ATLAS LIFE INSURANCE COMPANY,
Respondent.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT

AMICI CURIAE BRIEF FOR STATE AND LOCAL GOVERNMENTS IN SUPPORT OF AFFIRMANCE

Statement

This brief is submitted by representatives of States, counties, cities and other units of local government because the States and their subdivisions and the taxpayers represented by them have the largest stake in this review. We seek the affirmance of the unanimous decision of the Court of Appeals for the Tenth Circuit (in opinions per MURRAH, C. J. and BREITENSTEIN, J.), implementing the congressional "Exception" provisions so as to exclude interest on state and local government bonds from the computation of the tax on life insurance company income whenever the inclusion of such interest would produce a higher income tax.

The exemption protected by the Congress was not created for the benefit of life insurance companies or any other investors. They are mere conduits. State and local

governments are the beneficiaries. Without the adjustment authorized by the Exceptions, the conduit is clogged and the intended state and local government benefit is dissipated.

The apportionment or proration proposed by the Petitioner serves no purpose as between the company and its policyholders: the policyholders pay no tax. The actual proration would be as between the Federal Government and the States. What would be apportioned between them is the States' benefit from the exemption of state and local government bond interest.

For decades Congress has acted to assure the States and their political subdivisions that there would be no federal income taxation of the interest on their obligations. Accepting the urgent arguments of the States and their subdivisions that the exemption is critically important to their governmental independence and fiscal responsibility, Congress has consistently rejected Treasury Department attacks on the exemption whether mounted as frontal assaults for its outright repeal or as attempts to erode it in particular applications.

For decades the Treasury has represented to Congress that the exemption should be abolished or curtailed because it permits advantages to the investors in state and local government obligations and because it diminishes federal tax revenues. Every Treasury attempt has brought a confrontation with state and local government officers who detailed the importance of the exemption to state and local governments and the importance of state and local governments as vigorous partners in a federal system, and contended that any impairment of the exemption would be unconstitutional and harmful in practice. Not once has the Treasury position prevailed. By enacting the statutory exemption in the first and every subsequent income tax act and by refusing to repeal or amend it, Congress has adopted the state and local government viewpoint and, to use Petitioner's phrase, pretermitted the question of the constitutionality of the taxation which Congress declined to enact.

Thus, no investor in state or local government bonds has ever had to pay a federal income tax solely as a result of his receipt of interest on those bonds. This has been true with regard to every type of investor under every revenue act, whether he was an individual or a life insurance company or fell into any other category.

The question in this case is whether Congress in the Life Insurance Company Income Tax Act of 1959 has abandoned this consistent position and practice and instead sought the result that the receipt of state and local government bond interest shall produce an increase in income tax otherwise payable. The question is whether Congress intended that net result when it enacted both a formula and an "Exception" and where the formula in some, but not all cases, will produce that result and the "Exception" provides that "If it is established in any case that the [formula] * * * results in the imposition of tax on [state and local government bond interest] * * *, adjustment shall be made to the extent necessary to prevent such imposition." §§ 804(a)(6), 809(b)(4).

Petitioner argues that while Congress foreclosed any challenge to the continued *existence* of the doctrine of constitutional immunity of state and local government bond interest, Congress nevertheless deliberately provoked a judicial review of the constitutional *scope* of that immunity and specifically asked this Court to sanction a formula which, if adjustment is not made under the Exceptions, can result in a destruction of the major portion of the value of the exemption. It is the position of the States and their subdivisions that by the Exceptions, Congress sought to pretermit *any* constitutional question relating to the manipulation of state and local government bond interest in a statutory formula so that its receipt can produce a higher income tax. It is the position of your amici that Congress was as anxious to foreclose an attack which could dilute the beneficial effects of the immunity as to prevent an attack which would ask this Court to disestablish the immunity doctrine itself.

We agree with the Petitioner that "the function of the 'exception' clauses was to reassure those who were anxious to maintain the established immunity of State bonds and to prevent a defense of the statute which would cast that immunity in doubt." (Brief for Petitioner,[1] p. 15) We were among those seeking that reassurance and the reassurance we sought was not limited to the theoretical preservation of a truncated immunity but to the adjustment of the basic formula in every case in which it was established that higher taxes would result solely from the receipt of interest on the bonds issued by our States and subdivisions. We shared the *double* fear expressed by Senator Butler of the Senate Finance Committee (who as Petitioner admits (Pet. Br., pp. 66, 76) sparked the fight for the Exceptions), that the Treasury might make litigation under the Act the occasion (a) for seeking to have the whole doctrine of immunity overruled and (b) also for seeking to dilute its vigor and value by the device of "proration."

For that reason we resisted the House bill, which had no exceptions to prevent those results, and we supported the Senate bill which, over Treasury opposition, added the present Exception provisions to give us the reassurances we sought. When the House yielded and Congress enacted the Exceptions, we thought we had accomplished both our objectives, only to be told in this litigation that we had accomplished one but not the other.

Petitioner is faced in the present "Exceptions" with Congressional enactments which it concludes "are inoperative" (Pet. Br., p. 52) and "might well have been omitted." (p. 76). Faced with the absurdity of reading the Act as producing exactly the same tax result as if the "Exceptions" had not been enacted, Petitioner reads them so as to impute to Congress a deep concern to prevent judicial reexamination of the whole doctrine of immunity while at the same time imputing a willingness, even an eagerness, to provoke a constitutional litigation in which the Treasury would seek

---

[1] Hereafter cited as "Pet. Br."

to limit the value of the immunity to the States. As Petitioner says (p. 59), there is a conclusive presumption "that Congress acted rationally and not from schizophrenia."

Petitioner appears to miss the whole point of the Congressional intercession. *Why* should Congress have been so concerned to thwart a suspected Treasury plan to attack "the whole doctrine of immunity," as Petitioner concedes it was? (Pet. Br., p. 76) Obviously not out of whim or caprice but because Congress holds important certain values which the immunity doctrine strengthens and protects. The "Exception" provisions must then go at least so far as is necessary to preserve those values as a matter of congressional policy; to be implemented by administrators and courts and not to be whittled away or destroyed by them.

The question is not whether any administrator or court at any point in time might hold the same policy values in this respect as Congress always has. We are dealing with "Exceptions" which were concededly enacted to prevent the raising of constitutional issues. We submit that the proration device supported by the Treasury can undermine those values. We submit that Congress believes that the immunity, undiluted, maintains the role of the States in our federal system, that the federal system should be preserved and that the role of the state and local governments should not be diminished. We submit that Congress believes that the cost of borrowing by the States and their agencies can and should be substantially held down by the immunity doctrine and the States and local governments thereby encouraged and enabled to cope with local problems out of their own resources. We submit that Congress believes that it is advantageous that local problems should be solved at the local level to the maximum extent possible. We submit that these values are offended by any "device or form of words"[1] which imposes the penalty of additional taxes upon the investor in state and local government bonds solely

[1] *National Life Ins. Co.* v. *United States*, 277 U. S. 508, 519 (1928).

as a result of his receipt of interest thereon. We submit that these values are equally offended by such a result no matter how produced and that they are not preserved by labelling the resulting tax as one not "on" but merely resulting from the receipt of the interest which is supposed to be wholly tax exempt. We submit that it is a crass charge to impute to Congress in the field of federal-state relations a concern for form but not for substance, for semantics but not results.

We submit that the Petitioner has broken faith with Congress and precipitated the very constitutional controversy which Congress sought to avoid.[1]

POINT I

The reasons for the congressional concern to preserve the exemption of state and local government bond interest.

It was not only out of concern for constitutional propriety that Congress enacted and reenacted the exemption of state and local government bond interest and struck down every attempt to repeal or curtail it. As stated by the Ninth Circuit Court of Appeals in 1940:

> "It appears from congressional reports and debates that not only was the exemption enacted and reenacted because of doubt as to the effect of the Sixteenth Amendment on a source of income previously

---

[1] Once before, without waiting for Congressional sanction, the Treasury commenced what its press release called "a test action intended ultimately to prove in the courts that the Federal Government has the right under the Constitution to tax the income from State and municipal securities." (U. S. Treasury Dept. Press Service Release No. 24-3, March 14, 1941). While the rival views of the fiscal, economic and social impacts were aired in a full month of testimony and a mountain of exhibits in the Tax Court to prepare a record adequate for constitutional reevaluation, that Court declined to reach the constitutional argument, holding the bonds in question covered by the statutory exemption. *Shamberg* v. *Commissioner*, 3 T. C. 131 (1944). The Second Circuit affirmed, 144 F. 2d 998 (1944). This Court denied certiorari, 323 U. S. 792 (1945).

> declared immune by the Pollock case, but also on grounds of policy apart from the constitutional question." *Bryant* v. *Commissioner*, 111 F. 2d 9, 12.

Thus the Chief Counsel of the Bureau of Internal Revenue advised the House Ways and Means Committee in 1939 that

> "A study of the congressional debates and various committee reports in connection with the several revenue acts indicates that the failure of Congress to include interest from State and local securities in gross income is due in part to doubts as to constitutionality and in substantial measure to considerations of policy." Hearings, 76th Cong. 1st Sess., on Proposed Legislation Relating to Tax-Exempt Securities, p. 89

(1) The values to state and local government which Congress has chosen to protect.

The considerations of policy which Congress has appraised appear best by a review of the record in the three principal confrontations between the Treasury Department and Department of Justice on the one side, and the state and local government officers on the other.

In 1938-1940, 1942, and 1951, the Treasury Department and Department of Justice urged Congress to repeal the exemption and permit a new constitutional challenge. On each such occasion Congress retained the exemption intact after extensive hearings and testimony on both sides dealing principally with the fiscal, economic and social aspects of the proposal, and the impact on political balance between States and National Government in the federal system, as well as the constitutional aspects.[1]

---

[1] Hearings before the Special Committee pursuant to S. Res. 303 (75th Cong.) between January 18 and February 16, 1939; Hearings before the Committee on Ways and Means on Proposed Legislation Relating to Tax Exempt Securities, between June 28 and July 11, 1939; Hearings before the Senate Committee on Finance, Revenue Act of 1942, July 23 and August 3, 1942; Hearings before the House Committee on Ways and Means on the Revenue Revision of 1942, March 27, 1942; Hearings before House Committee on Ways and Means on the Revenue Revision of 1951, February 26 and February 27, 1951.

The Treasury for its part stressed the potential increase in federal revenues and the argument that investors receive an undue tax advantage. State and local government representatives stressed the serious impact of increased interest costs and minimized the predicted federal revenues. They discounted on several bases the argument that the investor receives an undue advantage, pointing out that the investor pays for the advantage in large part by accepting a lower interest rate, that the argument of tax advantage was more theoretical than real because the actual distribution of holdings of state and local government bonds showed that most of them were held by banks, other corporations, institutions and governments and not by individuals, and that millionaire estates had a very small proportion of their assets invested in such bonds. They contended that to achieve more nearly perfect progression in the federal income tax structure by eliminating the exemption, it would be necessary to meet increased interest costs by increased local taxes, principally real estate and sales taxes, which are for the most part regressive.

State and local government officers have also insisted that the problem is not only one of added cost to state and local governments, although that has been a paramount consideration. They have also stressed that the tax might make borrowing utterly impossible under many circumstances. Some municipalities could not sell their obligations on a taxable basis (Cf. R. 45). This might be because the additional cost of borrowing would be beyond the financial power of the affected municipality to bear.[1] In other cases projects which were to be provided only on a self-supporting basis would cease to be self-supporting because of the added

---

[1] When a floor amendment to repeal the exemption was proposed in 1938 it was defeated after arguments by Senators Tom Walsh and Alben Barkley that for

> "certain states whose financial difficulties are serious, and * * * certain counties and school districts * * * it would be practically impossible for them to raise money without the right to issue tax-exempt securities." 83 Cong. Rec. 5183.

cost of borrowing. In still other cases the municipality might be pushed beyond the statutory or constitutional limit on the rate it can pay. At a minimum, the tax would probably force a curtailment of governmental services at the state and local levels or increase the demand for federal aid or both.

But beyond that, assuming that a municipality would attempt to shoulder the burden of additional costs and keep its services unimpaired, the consequence would not be terminated when the borrowing first took place. Having assumed the added obligation, the municipality would have weakened its resistance to any subsequent jar to its economy. We are not so far from the times when the Municipal Bankruptcy Act was being applied that we can assume that municipal economies cannot collapse. As the Court said, "The notion that a city has unlimited taxing power is, of course, an illusion." *Faitoute Iron and Steel Co.* v. *Asbury Park,* 316 U. S. 502, 509 (1942).

It was to these continuing consequences of a tax on the interest from state and local obligations that the Court referred in *James* v. *Dravo Contracting Co.,* 302 U. S. 134, 153 (1937) when it said that the doctrine of immunity with respect to governmental bonds

> "recognizes the direct effect of a tax which 'would operate on the power to borrow before it is exercised' (Pollock *v.* Farmers' Loan & Trust Co., supra) and which would directly affect the government's obligation as a continuing security. Vital considerations are there involved respecting the permanent relations of the government to investors in its securities and its ability to maintain its credit * * *."

Finally, in all these Congressional debates the state and local officers stressed the governmental values of the federal system and the importance of protecting the proper place of state and local government and avoiding unnecessary centralization. They particularly feared that federal taxation would permit special exemptions for bonds issued for

favored federal policies of the moment and thus substantially displace freedom of choice of policies at the local level.[1] They invoked the opinion of Justices Douglas and Black that "The power to tax is indeed one of the most effective forms of regulation. And no more powerful instrument for centralization could be devised."[2]

These arguments show *why* Congress would not countenance an attack on the immunity doctrine and therefore why the operation of the Exceptions to foreclose that attack must be broad enough to protect not only some nominal doctrine of immunity but all the values so consistently preserved by Congress.

These considerations prompted your amici to seek amendment of the House bill involved in the present case. The objections of your amici could not be met by semantic distinctions between a tax on their bond interest and a tax "merely" resulting from receipt of their bond interest. They were trying to protect the market for their bonds from tax impact, no matter how labelled. They knew that a potential investor buys or passes up a "tax exempt" investment by gauging its after-tax value to him—i.e., by determining the relative after-tax result of receiving the coupon rate on the "exempt" bond and the higher rate on a taxable bond of comparable investment quality. The Record details that process in a typical Investment Committee (R. 45). It was the tax *result* admittedly flowing from the unadjusted formula which prompted the opposition to the House bill.

---

[1] Thus in the days of generalized attacks on the exemption of state and local government bonds, housing authority bonds were singled out for continued exemption. (Hearings before the Senate Committee on Finance, Revenue Act of 1942, p. 543.) But in 1954, when general exemption was free from attack, housing bonds were singled out for particular taxation. The proposal was withdrawn. (Ways and Means Committee press release dated February 8, 1954.)

[2] Dissenting in *New York* v. *United States*, 326 U. S. 572, 593 (1946). Referred to in Hearings before House Committee on Ways and Means on the Revenue Revision of 1951, pp. 909, 916, 923-5.

True, state and local government officers deemed the result unconstitutional but they also deemed it objectionable as a partial repeal of the traditional exemption, for all the reasons which Congress had accepted over the years.[1]

Therefore once it is conceded that Congress meant "to reassure those who were anxious to maintain the established immunity of State bonds" (Pet. Br., p. 15), it follows that Congress intended the remedy to be sufficiently potent to avoid the threatened ailment complained of.

It is true, as Petitioner says (p. 74), that Congress "considered all the arguments pro and con over the desirability of the effects the bill admittedly would have" including "any adverse effects the bill might have on the market for State bonds." But note that Petitioner cites no record reference when it asserts that Congress, having considered all these arguments, "decided on balance * * * that any adverse effects the bill might have on the market for State bonds were not great enough to warrant giving to insurance companies the unfair advantage of duplicating deductions or exclusions."

We conclude exactly the opposite because each time since 1938 when Congress has balanced the adverse effects a tax proposal would have "on the market for State bonds" against the alleged "unfair advantage" of the investors, the verdict, as we have seen, has been to the contrary.

---

[1] Indeed the Chairman of the Conference on State Defense, one of your amici, sought modification of the House bill to strengthen the state and local government bond market at a time when he still believed the formula met the minimum requirement of constitutional immunity. (Hearings before the Senate Finance Committee on H. R. 4245, 86th Cong., 1st Sess., [hereafter cited as "Hearings"] p. 121). It took careful study of the precise operation of the bill to uncover the fact that the formula produced a tax resulting from the receipt of state and local government bond interest. With such analysis completed, this state officer filed a second statement with the Senate Finance Committee while it was deliberating (but too late to be printed) correcting his prior erroneous constitutional opinion.

Therefore the Exceptions were devised to require adjustment "in any case" where the formula "results" in a higher tax than if the interest had been excluded from the calculations. Less does not fit the Congressional objective to protect state and local government.

(2) The effect of relative federal and state revenue needs on the congressional objective.

As against the recited gains for strong state and local government, what revenues did Congress give up by enacting the Exceptions? The estimate by the Treasury before enactment was "$35-$40 million" on the 1958 income.[1] The estimate by the life insurance company representative was "$32½ million."[2] Both these estimates, however, assumed an adjustment which is greater than the adjustment contended for by the Respondent and accorded by the Tenth Circuit. A computer calculation was recently made by analysis of 1132 actual income tax returns filed by life insurance companies who account for more than 90% of the total tax paid under the Act. It was determined that the difference in treatment of tax-exempt interest between the Tenth Circuit's view and the Petitioner's view is only $21.2 million a year on the average.[3]

The study also considered the possibility that an affirmance in this case might increase life insurance company investment in state and local government bonds. It reported the results of a calculation to determine the maximum revenue reduction possible if all companies switched to state and local government bonds to produce the maximum tax ad-

---

[1] Hearings, p. 51.

[2] Hearings, p. 317.

[3] The National Underwriter, March 6, 1965, p. 1, by J. S. Hill. The figure for 1964 is $21.0 million. The low was $18.5 million for 1958 and the high $24.4 million for 1962. In 1963 it was only 3½% of the total tax paid by these companies under the Act.

vantage to themselves.[1] It recognized that switching will occur only if the tax advantage exceeds the reduction in interest rates accepted by the company in buying state and local government bonds of comparable quality to the taxable bonds sold. Therefore, a separate calculation was made not only on the assumption that yields on tax-exempt bonds would continue to have the same ratio they now have to yields on taxable bonds but also on the assumption that the ratio would be reduced if there were any major attempt to fit the foot of the $141.1 billion life insurance company assets[2] into the shoe of the $86.9 billion total state and local government bond debt already held by others.[3]

Based on the fact that at the present time municipal bond yields range between 71% and 68% of the yield on comparable corporate bonds, the calculation showed that if the ratio held at 68%, then companies paying 84% of the aggregate taxes paid by all the companies for 1963 could not profitably have reduced their taxes at all; and that companies paying the remaining 16% of the aggregate taxes, if they could have switched $3 billion of their assets, could have accomplished a maximum reduction of $44.9 million out of a total tax collected of $651.0 million. If the increased demand by life insurance companies reduced the ratio of municipal to corporate yields to 64%, then companies accounting for 90% of the aggregate taxes could not have profitably reduced their tax at all; and the companies

---

[1] The article explained the process of calculation as follows: "A company * * * will not reduce taxes unless it can increase its income after taxes by so doing. Data from the 1963 tax returns were fed to the computer with a program which asked in effect, 'If an additional 1% of assets were switched to municipal bonds, would the after-tax income be increased?' This process was repeated as long as the answer was 'yes'. Running totals were kept of the total tax reduction and the amount of assets switched."

[2] 1964 Life Insurance Fact Book, p. 65.

[3] Annual Report of the Secretary of the Treasury for the Fiscal Year Ended June 30, 1963, p. 626. Actually for 1963, $3.9 billion (4.5% of the total outstanding in the hands of all investors) were already held by life insurance companies (2.7% of their total assets) 1964 Life Insurance Fact Book, p. 73.

accounting for the remaining 10%, by switching $2 billion of taxable securities into municipals, could at the outside have reduced their taxes by $32.0 million. As the yield ratio approached 60%, the ability for profitable switching was practically eliminated: companies accounting for 6% of the aggregate taxes were the only ones which could have done any profitable switching and the most they could have saved would be $9.8 million.

Of course, if this switch took place: (a) the present holders of the exempt securities would be switching tax-exempt into taxable investments and paying more taxes so that "total Federal revenues are unaffected"[1] and (b) relative to life insurance company taxes alone, if there is any additional federal loss it would be accompanied by additional state and local gain from the resulting interest reduction coming about from the strengthened market for state and local government bonds.

These figures should be appraised against the pattern of relative federal and state fiscal needs which was already emerging in 1959 and has recently become so apparent. The New York Times of February 1, 1965 (p. 13) contains an article by Joseph A. Loftus entitled "Fiscal Myth Exploded" and sub-titled "State and Local Budgets, Not Federal, Are Soaring—And Will Do So in Future." The article reports "State and local budgets are rising, and will continue to rise, because the fastest growing functions of government operate at those levels." It points out that "Forty per cent of state and local spending goes for education. More than 70 per cent goes for education, highways and health and welfare." These are the functions which increase most directly in proportion to the increase in population.

The article continues:

> "In five years or so, if there is no dangerous change in international relations, annual state and

[1] Hearings, p. 689. If the present holders switching their tax-exempts into taxables pay income taxes at higher rates than the life insurance companies, the net effect of the switch might even increase total federal revenues.

local spending will pass total Federal spending, including money for defense and foreign aid.

• • •

"No one disputes the fact that the states are struggling with real problems, that these problems are growing in size and complexity, and that Federal-state fiscal relations will affect the future nature of the Federal system."

Such a discussion is significant as background for congressional evaluation of arguments pointing out the adverse effects of "proration" on the market for state bonds. Thus another article[1] describes problems which arise "Since the Federal Government is likely to have embarrassingly large tax revenues in the future and since the states will unquestionably have embarrassingly small ones; and since the Federal Government is inhibited, for various reasons, from embarking on large-scale new expenditure programs, whereas the states have so much to do that they don't know what to do first • • •".

The article refers to "the already large, awesomely mounting total of state and local needs. In part the trouble here stems from our 'baby boom' of the late nineteen-forties. What was then only a perambulator parade has now swept through our elementary and high schools, and is in the process of inundating our colleges. As a result, state and local expenditures on education have exploded. Three billion dollars in 1945, $7 billion in 1950, $11 billion in 1955, $22 billion today and probably around $50 billion by 1975."

The article continues: "But education is not the only source of vastly expanded state and local expenditures. As urban and suburban areas have grown and population densities have increased, the cost of maintaining health and sanitation, recreation and transportation, welfare and simple public order has increased disproportionately. According to the National Planning Association, total spending by the states, towns and cities, already over $55 billion, will rise in another ten years to almost $155 billion."

---

[1] New York Times Magazine of December 27, 1964 (pp. 8, 30, 31, 33), by Robert L. Heilbroner.

Since during the 1940's, when the Federal Government's needs were growing relative to the needs of the States, Congress did not deem "any adverse effects * * * on the market for State bonds" outweighed by the claim of "unfair advantage" to investors (Pet. Br., p. 74), it would seem to require proof—and the Petitioner has offered none—that Congress should in 1959 have brushed aside the admitted adverse effects of the Treasury proposal when the States face explosive needs relative to the Federal Government's.

It was more than reasonable under these circumstances that Congress should not only have been anxious to discourage "adverse effects * * * on the market for State bonds" but ready to give active encouragement to life insurance company investment in state and local government bonds to strengthen the market for them. Actually, as we have seen (supra, p. 13), there were during 1963 $141.1 billion of total assets of United States life insurance companies of which only 2.7% or $3.9 billion was invested in state and local government obligations.[1] For the same year there was an additional $82 billion of such obligations owned by others for an aggregate of $85.9 billion.[2]

With the growth in state and local debt bound to accelerate, even a small percentage increase in life insurance company holdings as a result of the 1959 Act would ease the financial pinch in which state and local governments were increasingly finding themselves. Per contra, Petitioner's interpretation would aggravate an already serious problem by creating new "adverse effects * * * on the market for State bonds." We submit that Congress accepted the view of your amici and not Petitioner's.

---

[1] 1964 Life Insurance Fact Book, pp. 65, 73. The total assets figure increased each year from the level of $113.6 billion for 1959. The percentage of these 1959 assets invested in state and local bonds was 2.8%; it was 2.7% in 1963. This percentage was down from a high of 6.8% in 1940.

[2] Annual Report of the Secretary of the Treasury for the Fiscal Year Ended June 30, 1963, p. 626. Expressed as a percentage of all state and local government bonds outstanding, the life insurance company holdings were 5.2% of the total in 1959 and had declined to 4.5% in 1963.

POINT II

The scope of the traditional immunity of state and local government bond interest which was protected by the Congress in the Exception provisions.

We do not understand the order of the points in Petitioner's brief. Petitioner begins with a vigorous 33 page defense of the constitutionality of the basic formula and then proceeds to the perfect non-sequitur that "Since the statutory apportionment does not violate the assumed constitutional prohibition against a tax on state-bond interest, the 'Exception clauses' are inoperative." (p. 52).

As a matter of simple logic, since the Exception clauses are exactly what they are called, they must displace the basic formula wherever applicable and this is so whether or not the formula might be deemed constitutional. The question of the validity of the unadjusted formula is foreclosed by the Exceptions.

(1) The Exceptions should be interpreted to avoid, not to raise grave constitutional questions.

The first inquiry should therefore be into the scope of the Exceptions. Only if these can not possibly be interpreted to avoid the intense constitutional question is there any reason for the Court to confront it. If any straining is to be done in construing a statute it must be "in the candid service of avoiding a serious constitutional doubt" and should be indulged so long as the interpretation which has that result "is not barred by intellectual honesty." *United States* v. *Rumely*, 345 U. S. 41, 47 (1953). Or, as Mr. Justice Holmes said, "A statute must be construed, *if fairly possible*, so as to avoid not only the conclusion that it is unconstitutional, but also grave doubts upon that score." *United States* v. *Moy*, 241 U. S. 394, 401 (1916) (Emphasis added). See also *Crowell* v. *Benson*, 285 U. S. 22, 62 (1932); In re *Coates*, 9 N. Y. 2d 242, 253 (1961), app. dism., 368 U. S. 34 (1961).

Petitioner's interpretation not only fails to avoid grave doubts of the constitutional propriety of taxing the result of receiving State or local government bond interest; it unnecessarily raises that constitutional question and spends 33 pages defending its position. The Tenth Circuit's interpretation, on the other hand, has interpreted the Exceptions so as to avoid constitutional question and this was done not only without straining, but by giving the Congressional words their ordinary meaning.

According to Petitioner, nevertheless, the sole function of the Exceptions was to prevent a defense of the statute which would cast doubt on "the traditional constitutional immunity," "the established immunity of State bonds." (Pet. Br., pp. 14, 15). This was, of course an important function, but not the sole one. Since, however, Petitioner's case fails completely if the "traditional" and "established" immunity has not in the past encompassed proration as an allowable technique, we shall appraise the Exceptions in the light of the very test produced by the Petitioner.

(2) The origin and scope of the traditional immunity—no taxpayer has ever been required to pay a higher income tax solely as a result of the receipt of state or local government bond interest.

We are, therefore led to an inquiry as to what the scope of the "traditional" and "established" immunity has been. We are confirmed in this approach not only by the Petitioner's concession but by the fact that the Exception provisions identify the interest on which no tax is to be imposed as "any interest which under section 103 is excluded from gross income." (Sec. 804(a)(6)(A) and Sec. 809(b)(4)(A)).

Section 103 and all of its predecessors and all of its counterparts in life insurance company income tax acts have produced one invariable result in their codification of the "traditional" and "established" immunity:—under every single tax act, every taxpayer, including every life insurance company, has been authorized to exclude all of his or its state and local bond interest from the base upon which

his or its tax is computed; no investor in such bonds under any of these acts has ever been required to pay any taxes at all solely by reason of his receipt of interest on his loan to state or local government.[1] The "traditional" and "established" immunity has never meant that it was enough to tell the investor that state or municipal bond interest would increase his tax but by a smaller increment of tax than if the interest were paid by American Telephone & Telegraph Co.

When Congressman Cordell Hull introduced the bill to establish the first income tax in the Revenue Act of 1913, he explained that the exemption therein afforded to interest on bonds of States and their political subdivisions (which has ever since been retained and is now Code § 103) was included for the following reason:

> "* * * not desiring to raise any constitutional question, or to arouse the antagonism of any of the States, this provision was inserted." (50 Cong. Rec. 508).

"The antagonism of the States" which Congress thus sought to avoid could not then, any more than now, be averted, by a "device or form of words"[2] or by "ingenuity in calculation"[3] but only by *results* which preserve to them the *full* value of their immunity in reduced interest costs and resulting benefits.

The "constitutional question" which Congressman Hull did not want to raise again was, of course, the question settled in *Pollock* v. *Farmers' Loan & Trust Co.*, 158 U. S. 601, 630 (1895) in which the Court said:

> "We have unanimously held in this case that, so far as this law operates on the receipts from municipal bonds, it can not be sustained, because it is a tax

---

[1] The provision of the 1921 Life Insurance Company Act which would have been an exception to the statement in the text was the provision struck down in *National Life Ins. Co.* v. *United States*, 277 U. S. 508 (1928).

[2] Ibid. at p. 519.

[3] *Missouri* v. *Gehner*, 281 U. S. 313, 321 (1930).

> on the power of the states, and on their instrumentalities to borrow money and consequently repugnant to the Constitution."

It will be noted that in *Pollock* the Court indicated that what was objectionable was that "this law *operates on* the receipts from municipal bonds." This presaged the decision in *National Life Ins. Co.* v. *United States*, 277 U. S. 508 (1928), where the Court struck down a "device or form of words" which could also be said to "operate on the receipts from municipal bonds": it increased taxes and disallowed the benefit of the exemption to the investor, and therefore the governmental issuer, by reducing a deduction otherwise allowable to the investor. The Court said (at pp. 519, 520, 522):

> "One may not be subjected to greater burdens upon his taxable property solely because he owns some that is free. No device or form of words can deprive him of the exemption for which he has lawfully contracted.
>
> "* * * The burden from which federal and state obligations are free is the one laid upon other property. To determine what this burden is requires consideration of the mode of assessment, including, of course, deductions from gross values. What remains after subtracting all allowances is the thing really taxed.
>
> * * * *
>
> "Congress had no power purposely and directly to tax state obligations by refusing to their owners deductions allowed to others."

At this point it was clear that the "traditional" and "established" constitutional rule with regard to state and local bond interest was that it should not be the occasion of greater tax burdens, whether they resulted from the direct inclusion of the interest in gross income or by the reduction of deductions otherwise available.

It is true that "proration" was not involved in the Act passed on in *National Life*. Proration consists of the partial

rather than the complete disallowance of the immunity by reducing otherwise allowable deductions to the extent of a part but not all of the immune interest. Any residual doubt that proration was an available technique to qualify the "traditional" and "established" immunity and disallow it pro tanto did not survive *Missouri* v. *Gehner*, 281 U. S. 313 (1930). It is true that *Gehner* involved the immunity of federal bonds from state taxation rather than the reverse and that it dealt with a property tax involving the proration of liabilities rather than deductible expenses. But these are distinctions without a difference. Proration was what the Court struck down and it did so on the precedent of *National Life* which did deal with state and local government bond interest and with an income tax. Proration was condemned because "Neither ingenuity in calculation nor form of words in state enactments can deprive the owner of the tax exemption established for the benefit of the United States. Nat'l Life Ins. Co. v. United States, 277 U. S. 508, 519, and cases cited * * *." 281 U. S. at 321.

It is significant that in *Gehner* the Court identified the exemption it was protecting from being burdened by the proration technique as "the tax exemption established for the benefit of the United States." By the same token the immunity asserted in *Pollock*, *National Life* and the present case is an immunity "established for the benefit" of the States. As Mr. Justice Cardozo said of the *Pollock* case in *Hale* v. *Iowa State Board*, 302 U. S. 95, 107 (1937):

> "By the teaching of the same case an income tax, if made to cover the interest on Government bonds, is a clog upon the borrowing power * * *."

The same reasoning emerges in *Helvering* v. *Gerhardt*, 304 U. S. 405, 417 (1938). There Mr. Justice Stone wrote that state immunity has been sustained where "the function involved was one thought to be essential to the maintenance of a state government: as where the attempt was * * * to tax income received by a private investor from state

bonds, and thus threaten impairment of the borrowing power of the state, Pollock v. Farmers' Loan & Trust Co."[1]

1942 brought a renewed attempt to secure repeal of the basic statutory exemption of state and local government bond interest and, as we have seen (supra p. 7), once again the Congress adopted the state and local viewpoint and retained the exemption intact.

1942 also brought a new Life Insurance Income Tax Act which, Petitioner claims, adopted the proration technique (Pet. Br., p. 17). But the fact is that under the 1942 Act, life insurance companies, like investors of every other class before and since, were allowed and required to pay the tax and only the tax which they would have paid if they had not entered into the transaction which resulted in their receiving state and local government bond interest. An example of this effect of the 1942 Act appears in the Record which shows

---

[1] It was the *Gerhardt* case which precipitated the first major confrontation between the Treasury Department and the Department of Justice on the one side and state and local government officers on the other with regard to the proposal that Congress repeal the exemption of state and local government bond interest. After the decision in 1938, the Attorneys General of the various States organized the Conference on State Defense to fight the repeal of bond interest tax exemption. In response to their invitation all of the standing organizations of executive, legal and fiscal officers at the state, county and municipal levels and the organizations of state, county and local governments joined together in the Conference on State Defense which they have maintained these past 27 years. Your amici include those organizations.

The Department of Justice produced a study identified by the Petitioner (Pet. Br., p. 19, fn. 6). The Attorneys General of the States produced a counterstudy of 420 pages entitled "The Constitutional Immunity of State and Municipal Securities—A Legal Defense of the Continued Integrity of the Fiscal Powers of the States." A large scale report was prepared for the Comptroller of the State of New York entitled, "The Fiscal and Economic Aspects of the Taxation of Public Securities". All these studies were submitted to and evaluated by the Congress along with a mass of testimony on both sides which culminated on September 19, 1940 in the defeat of the proposal to end the exemption (86 Cong. Rec. p. 18621).

that the elimination of state and local government bond interest from the tax computations thereunder would not alter the actual tax payable (R. 45-6).[1]

In any event, by 1951 Congress had abandoned this approach and under each of the intervening acts as in the case of the 1942 and all prior acts (including 1921 after adjustment under *National Life*), it remained true that the receipt of state and local government bond interest in any tax year never involved for a particular life insurance company or any other taxpayer an additional tax liability for that year.

1951 also brought the Treasury's third frontal attack on the basic exemption since 1938, and it was defeated like the earlier ones (see p. 7, supra). Every Congress since

---

[1] In the 1942 Act, state and local government bond interest was deducted from the company's gross income before the deduction for reserves and never appeared thereafter in the computation of the particular company's net taxable income. Congress permitted a deduction from the taxable income of an amount representing the expense requirement for additions to reserves. This deduction was to be a ratio computed annually in part on the basis of the total investment income of the entire life insurance company industry including tax exempt interest. Each life insurance company would pay the corporate tax rate on the remaining percentage of its own taxable investment income, whether or not the published ratio described its own additional reserve requirements and whether or not it had any tax exempt interest. Thus, while some tax exempt interest could enter into the computation of the industry-wide ratio, the actual tax of a particular life insurance company for any year was not increased by a penny because of the receipt of tax exempt interest that year. As MURRAH, C. J. observed below (R. 106-7):

> "But no taxpayer was induced to test the added tax burden as against the doctrine of *National Life*, apparently for two reasons: (1) the industry-wide reserve deduction percentage was so great that the individual company's net taxable investment income was miniscule; (2) each company could minimize its tax burden by purchasing tax-exempt securities because the income therefrom was not included in the computation of their individual tax liability."

has seen the introduction of bills to repeal or limit the exemption, but none has even reached the stage of hearings and none has been reported to the floor of either House.

The tradition is thus intact. No taxpayer of any class has ever had to pay a higher income tax solely as a result of receiving state or local government bond interest.

(3) Fairness forbids rather than requires the proration technique.

The arguments in Petitioner's Point I relate to a question with which we are not here concerned: the question of how to apportion a tax burden between the company and its policyholders. To such a controversy alone is there any relevance to Petitioner's contention that "Not only is that allocation perfectly reasonable but there is, we submit, no fairer method by which the allocation could be made." (p. 35).

But that is not the controversy here. Here we have a problem in federal-state relations and in the view of Congress as to what is fair as between the Federal Government and the States, not as between the company and its policyholders. On that subject Congress has already given its view contemporaneously with the present Act when in 1959 it amended the exemption of federal bonds from state taxation to provide:

> "This exemption extends to every form of taxation that would require that either the obligations or the interest thereon, or both, be considered, directly or indirectly, in the computation of the tax * * *." (73 Stat. 622).

The amendment was explained as being merely confirmatory of the prior simple statement of exemption. (Senate Report No. 909, 86th Cong., 1st Sess., p. 8).

This is the rule for which we contend. It requires adjustment whenever the interest if "considered directly or indirectly in the computation of the tax" would increase the

amount due. Proration of federal interest payments is thus outlawed for state income taxes. We may take this as the judgment of Congress in the same year in which the present Act was enacted, that proration has no place in the field of intergovernmental immunities—that as between the Federal Government and the States it is not only not a "fair" technique but a forbidden erosion of the traditional exemption.

The standard of "fairness" also suggests equality of treatment between different classes of taxpayers. If this standard is used in interpreting the Exceptions, then Petitioner has produced no evidence to dispel the conclusion that Congress wanted to treat all taxpayers alike to the end that state and local governments should have the full benefit of the traditional immunity from all potential investors.

The Exceptions themselves refer to Section 103 to identify the type of interest dealt with, although that Section has no direct operative effect on life insurance company income. Under Section 103 every other taxpayer excludes all interest from state and local government bonds in the computation of his or its tax and never pays a higher tax solely by reason of the receipt of such interest. Banks are not subject to a proration dilution of the exemption of their tax exempt bonds. The fact that some of their assets result from deposits on which they are indebted to the depositors does not change this result. The expense of paying interest on these deposits is deductible in full as an expense of doing business and is deducted from the taxable income only; state and local government bond interest does not enter into the computation.[1]

Petitioner's argument that Congress deemed proration to be the only fair method cannot stand alongside the fact that only by adjustment in accordance with the Exceptions could the basic formula of the Act be brought into line with what was deemed fair for all taxpayers including life insurance companies. Petitioner's argument that the required interest addition to reserves of life insurance companies is a "cost of producing income held constitutionally

---

[1] Rev. Rul. 61-222, 1961-2 CB 58.

immune from federal tax" (p. 36) is also opposed to the standard which has always been used to determine the cost of producing tax-exempt income. In order for an interest expense to be a cost of producing tax-exempt income, it must be an interest expense which would not have been incurred if the tax exempt investment had not been made. The life insurance company's actual required interest addition to reserves is a fixed interest expense; it must be made each year whether or not tax-exempt bonds are held and its amount is wholly unaffected by the company's choice of investment portfolio. Petitioner seems to have confused an unavoidable interest expense of doing business with a contingent interest expense of producing tax-exempt income. Only the latter is traditionally non-deductible. See Int. Rev. Code § 265(2).[1]

---

[1] The disallowance of interest on loans specifically incurred to purchase or carry tax exempt bonds has been in the law since 1918. It is the provision held constitutional in *Denman* v. *Slayton*, 282 U. S. 514 (1931). In 1933-34 the Treasury proposed a modification to require a proration reduction of a portion of the interest paid. The House passed such a provision in the Revenue bill of 1934 (H. R. 7835, 73rd Cong.). The Senate Finance Committee refused to concur and said in its report:

> "Your committee is of the opinion that the change made by the House bill will seriously interfere with the marketing of government securities, which are bought for the most part by banks and financial institutions • • •." (Senate Report No. 558, 73rd Cong. 2d Sess. p. 24).

The House receded (House Report 1385, 73rd Cong. 2d Sess. p. 17) and the law retained its traditional form.

Internal Revenue Service Technical Information Release (TIR-348) dated December 1, 1961 states:

> "The Internal Revenue Service announced today that the provisions of Section 265(2) of the Internal Revenue Code of 1954 have no application to interest paid on indebtedness represented by deposits in banks engaged in the general banking business since such indebtedness is not considered to be 'indebtedness incurred or continued to purchase or carry obligations • • •' within the meaning of Section 265 • • •."
>
> "The Service stated that although this has long been the position of the National Office of the Service, no specific publication of this point had been made."

The plea for equality of treatment between all classes of taxpayers, in the interest of fairness, was made in the legislative history, which we will review in Point III.[1] It was accompanied by warnings as to the dire effects which would flow from the extension to individuals, banks and others of the proration technique of eroding traditional immunity.[2] The Petitioner's new concept of expenses attributable to the cost of producing tax-exempt income makes those warnings particularly pertinent.

At this point it is enough to note that equality of treatment of all classes of taxpayers has been a part of the operation of the "traditional" and "established" immunity and that for all such taxpayers it has always been true that they have not been required to pay a higher income tax solely as the result of the receipt of state or local government bond interest.

The catchy label of "double allowance" (Pet. Br., p. 53) has never been used to prevent the exclusion of all their tax-exempt interest from the tax base of individuals, banks, insurance companies and others, although they may deduct all their costs of doing business from their taxable income alone. Or if Petitioner insists on calling this treatment a

---

[1] Hearings, pp. 47-8 (Sen. Talmadge, quoted infra p. 43), 58 (Sen. Hartke), 700 (Sen. Butler, quoted infra p. 40), 106 (Mr. Shanks, quoted infra p. 40), 187 (Mr. Taylor), 305 (Mr. Cummings).

[2] See infra pp. 37-40. It is interesting to note that after the passage of the present Act, at least three local Internal Revenue Agents, zealous to apply the "logic" of the proration approach taken by the Petitioner in the present case, attempted in Massachusetts, Mississippi and New York to levy deficiency assessments on banks which had received state and municipal bond interest, by disallowing a portion of their interest payments to depositors. These attempts were, however, finally dropped, TIR-348, *supra*, p. 26. They too would have violated the traditional immunity and exemption of state and local government bond interest.

"double allowance", then the answer is that the "traditional" and "established" immunity and exemption encompass such an allowance.

(4) By citing cases in other fields Petitioner is venturing its prediction of the future of the immunity doctrine and not recognizing the doctrine's "traditional" and "established" scope as required by Congress.

"Tradition" and what is "established" must be found in the past, not in the future. When Petitioner seeks to derive from other cases, not dealing with the immunity doctrine, "a living, growing body of principles" (p. 59) allegedly inconsistent with *National Life* and *Gehner*, it is really suggesting that sometime in the future, perhaps in this case, the Court may be persuaded to depart from their teaching. Petitioner is thereby violating its own standard of applying the "traditional" and "established" immunity which it admits Congress sought to maintain. However phrased, Petitioner is merely venturing its prediction of the future, not reading the past.

The cases cited by Petitioner cannot change the tradition which Congress has chosen to respect. But at any rate they are not even inconsistent with the immunity cases themselves.

Of Petitioner's cases only *Denman* v. *Slayton*, 282 U. S. 514 (1931) has anything to do with state and local government bond interest. There the taxpayer by borrowing money to buy the bonds tried not merely to preserve but actually to reduce his otherwise tax liability. He tried not only to exclude in full his exempt interest like all other bond holders, but to deduct also the interest he paid to borrow the money and which he would not have had to pay if he had not bought the bonds.

National Life, Gehner and *Slayton* are perfectly consistent with each other. They all stand for the proposition that the transaction which produces tax exempt interest or holdings should have no tax effect: neither an increase in the tax as in *National Life* or *Gehner* and in the present case under Petitioner's theory; nor a decrease in the tax as was attempted in *Slayton*. Losing counsel in *Slayton* argued, as does Petitioner, that his client's position was the same as the position of the National Life Insurance Company. The Court, in an opinion written by the same Justice who wrote the opinion in *National Life*, dismissed this contention out of hand saying:

> "The circumstances disclosed in National Life Ins. Co. *v.* United States were radically different from those now presented, and the doctrine upon which that cause turned does not control the present one. The respondent here was not in effect required to pay more upon his taxable receipts than was demanded of others who enjoyed like incomes solely because he was the recipient of interest from tax free securities—a result which we found would have followed enforcement of the literal provisions of §245(a), Revenue Act of 1921, 42 Stat. 227, 261." 282 U. S. at 319.

Similarly, *Helvering* v. *Independent Life Insurance Co.*, 292 U. S. 371, 381 (1934) noted "the distinction between that exclusion from deductions [involved in *Slayton*] and the taxation of exempt securities condemned in Nat. Life Ins. Co. v. United States."

As for *Independent Life Insurance Co.* itself and the other "analogies" by which the Petitioner predicts the demise of *National Life* and *Gehner*, if only Petitioner can persuade this Court to review them, we invoke the language of Chief Justice Hughes, joined by Justices Stone, Brandeis, Cardozo and Black that

> "There is no ineluctable logic which makes the doctrine of immunity with respect to government bonds

> applicable to the earnings of an independent contractor rendering services to the government. That doctrine recognizes the direct effect of a tax which 'would operate on the power to borrow before it is exercised' (Pollock *v.* Farmers' Loan & Trust Co., supra) and which would directly affect the government's obligation as a continuing security. Vital considerations are there involved respecting the permanent relations of the government to investors in its securities and its ability to maintain its credit; considerations which are not found in connection with contracts made from time to time for the services of independent contractors." *James* v. *Dravo Contracting Co.*, 302 U. S. 134, 152-3 (1937).

When there is no "ineluctable logic" which applies the immunity of state and local government bond interest to other situations even though they have some relationship to government, it goes without saying that the remote "analogies" invoked by the Petitioner are no basis for predicting a future change in the scope of immunity. A fortiori they have nothing to do with the scope of the "traditional" and "established" immunity as it has been in the past.

After *Dravo* and *Gerhardt*, critics of the traditional immunity began predicting its immediate total demise (see Pet. Br., pp. 18-19), although both those cases acknowledged the continuing vitality of the bond interest tax immunity. It was fashionable with these critics to dismiss as a cliché, and at any rate as inapplicable to the States, Chief Justice Marshall's statement in *McCulloch* v. *Maryland*, 4 Wheat. 316, 431 (1819) that "the power to tax involves the power to destroy."

Yet eight years after *Gerhardt*, Justices Douglas and Black wrote in *New York* v. *United States*, 326 U. S. 572, 592-4 (1946):

> "But it is antagonistic to the very implications of our federal system to say that the power of Congress to lay and collect taxes, Article I, § 8, includes the power

to tax any state activity or function so long as the tax does not discriminate against the States.

* * * * *

"A tax is a powerful, regulatory instrument. Local government in this free land does not exist for itself. * * * Local government exists to provide for the welfare of its people * * *. Many state activities are in marginal enterprises where private capital refuses to venture. Add to the cost of these projects a federal tax and the social program may be destroyed before it can be launched. In any case, the repercussions of such a fundamental change on the credit of the States and on their programs to take care of the needy and to build for the future would be considerable. * * *the power to tax lightly is the power to tax severely. The power to tax is indeed one of the most effective forms of regulation. And no more powerful instrument for centralization of government could be devised.

* * *

"The immunity of the States from federal taxation is no less clear because it is implied."[1]

In any event our quest is not for the future of the tax immunity doctrine but for its "traditional" and "established" scope in the past.

---

[1] Justices Frankfurter and Rutledge clearly did not agree with this dissent. The concurring opinion of Chief Justice Stone, joined by Justices Reed, Murphy and Burton accepted its philosophy but thought it inapplicable to New York State's "mineral water business." They said (at p. 586-7) "But we are not prepared to say that the national government may constitutionally lay a non-discriminatory tax on every class of property and activities of States and individuals alike. * * * a federal tax which is not discriminatory as to the subject matter may nevertheless so affect the State, merely because it is a State that is being taxed, as to interfere unduly with the State's performance of its sovereign functions of government."

Apart from problems in federal-state relations there is still another reason why the Court should decline to pursue the constitutional question raised in Petitioner's Point I. Even if the Exceptions could possibly be considered an invitation to the Court to tax state and local government bond interest to the extent that it does not offend the Constitution as it might be read today, we are led by *Helvering* v. *Griffiths*, 318 U. S. 371 (1943) to the result reached by the Tenth Circuit below. When Congress provided that a stock dividend shall not be treated as a dividend "to the extent that it does not constitute income to the shareholder within the meaning of the Sixteenth Amendment to the Constitution," the Court stated that it was nevertheless required to apply its own previous constitutional decisions, to ignore a claimed intervening trend against them, and not to reopen them to the end of enlarging the taxing power. Congress is deemed, without very specific evidence to the contrary, to be legislating within the limits of constitutionality as previously announced by this Court. Here, the comparable result is that Congress has enacted a requirement to make adjustments to meet the rule of *National Life* and *Gehner* as they stand. This is especially so since these cases were specifically stressed in the legislative history.[1]

Petitioner would distinguish *Griffiths* (Pet. Br., p. 61) as answering a question whether Congress "had in fact 'wanted' to tax" certain stock dividends. We have already shown in Point I what Congress "wanted" here. (See also Point III on legislative history). The fact remains that when Congress concededly invited a constitutional reexamination, the Court declined in *Griffiths*. A reexamination here should be denied a fortiori, since we start with Exceptions which are concededly intended to pretermit a constitutional question and the question is one in the delicate field of federal-state relations which the Court might well regard as requiring more stability than the field of stock dividends.

---

[1] Hearings, pp. 43-4, 50-1, 305, 308, 516-18, 700-2.

Petitioner takes the position that by the Exceptions Congress "wanted" to foreclose constitutional litigation involving a reexamination of the existence of the immunity rule, but to provoke constitutional litigation involving a reexamination of the scope of the same rule. The only evidence offered is that Congress enacted a formula which must in some cases (but not all, as we shall show infra, pp. 49-51) be adjusted under "Exceptions" enacted at the same time. The Petitioner says (pp. 57-9) that to impute to Congress an intention that an enacted "Exception" shall undo an enacted rule in described cases, is to impute "self-contradiction," "schizophrenia" and action which is not "rational." To us it is a violation of the meaning of the word "Exception" to do otherwise and we submit that to impute to Congress a Janus-headed approach of both foreclosing and provoking grave and closely related constitutional questions in the delicate field of federal-state relations, is to impute "self-contradiction," "schizophrenia" and action which is not "rational."

(5) Petitioner's theory cannot explain the portions of the Exceptions which do not relate to the traditional immunity doctrine.

Most significantly, Petitioner's interpretation ascribes no meaning whatsoever to subdivisions "B" and "C" of the two Exception provisions.

Congress specified three classes of income which might occasion adjustment, and state and local government bond interest is only one of the three. The second class is the so-called partially tax-exempt Federal Government bond interest and the third is intercorporate dividends. These are classes of income which have nothing to do with the question of constitutional immunity of state bonds, which, according to Petitioner is the sole reason for the Exceptions. By the remotest stretch of the imagination, the failure to adjust with regard to them cannot raise this constitutional question and the taxation of corporate dividends cannot

raise any constitutional question at all.[1] How then can it be called "a fully satisfactory explanation of the 'exception' clause" that it "forestall[s] any challenge to the immunity of State bonds as a constitutional doctrine" (Pet. Br., p. 76)? With no such constitutional question to be "forestalled" for federal bond interest and intercorporate dividends, what role can be ascribed to these other integral parts of the same Exception provisions? Under what circumstances is adjustment to be made under them?

We suggest that the Tenth Circuit's rule does not suffer the vice of this failure to account for all the parts of the Exception provisions. The test of the Court below fits all three branches of the Exceptions. If the inclusion of the identified items of income produces a higher tax than if these items were excluded, then the adjustment is made with the exclusion so indicated.

(6) The Tenth Circuit's interpretation gives the language its normal meaning.

The test adopted by the Tenth Circuit fits the view that Congress was looking for certain pragmatic results and was not indulging in a semantic exercise as to the difference between a tax "on" items of income and a tax resulting from its receipt. Members of Congress are more likely to be concerned with the dollars and cents results of two rival tax proposals than with the niceties of philosophical causation.

In the Exception clauses, Congress called for adjustment if it is established in a particular case that the formula "results in the imposition of tax on" the identified items of income. The use of the word "results" was apt. It tends to refute Petitioner's semantic distinction between a tax "on" an item of income and a tax which "results" from its receipt.

---

[1] There may be the very different question of impairment of the Government's contract obligations to its own bondholders if the Exceptions are deemed "inoperative."

We submit that Congress simply did not use the word "on" in the same way Petitioner does. It used the word in the way it is used in normal parlance.

Suppose an individual Congressman has in his checking account $75 more than he thinks he should keep idle, and he is about to buy a United States Savings Bond and wants to ask how the interest will affect his income tax. Is there any more natural way for him to phrase his question than to ask "Is there any income tax on the interest?" And would not the normal reply be: "You have to pay a federal income tax on the interest. But there is no state income tax on it." Does not the word "on" fit naturally?

What standard would have been used in asking or answering this routine question? It would be the normal standard of whether or not the item of income, if received, would add to the total income tax otherwise payable. And the "extent" of the tax "on" the interest would simply be the amount of tax the interest would add.

If this is a simple explanation, we count that as its prime virtue in seeking the intent of a Congress consisting of members of dozens of businesses and professions only a few of whom would claim to be tax philosophers. The virtue of this simple explanation cannot be destroyed by calling it "simplistic" and a "but-for" approach. (Pet. Br., pp. 22, 57, 59) Evidence, not epithet, is needed to reject the simple meaning of Congressional language when it reconciles all of the problems presented and squares so neatly with the Petitioner's own test of an intention to foreclose any challenge to the "traditional" and "established" immunity.

The evidence of legislative history, contained in our next point, only fortifies the conclusion reached by analyzing what Congress really "wanted," and what the scope of the "traditional" and "established" immunity has always been.

POINT III

The legislative history of the Act shows that Congress intended the basic formula for taxing life insurance companies to be displaced and adjusted in the case of any taxpayer whose tax under the basic formula would be increased solely as a result of its receipt of state or local government bond interest.

State and local government officers did not participate in the legislative history of the present Act until after H. R. 4245 was passed by the House. We were simply not aware at the time that the House bill produced the result which it did.

Let us review the approach and effect of the House bill. That bill did not rely on attribution of life insurance company income to policyholders to produce the tax result which the draftsmen desired in the case of the receipt by a life insurance company of interest on state and local government bonds. The approach was straightforward. The insurance company was required to go through the elaborate mathematical computations which produced its taxable income and each of the deductions to which it would be entitled. In arriving at the tentative tax base there was at first a total exclusion of all of the state and local government bond interest which the company might have received. Then, there occurred the "add-back" provisions (Sections 805(e) and 809(f)). The insurance company was thereby required to add back to the otherwise tax base a portion of the interest it had received on state and local government bonds and which had up to that point in the calculation been totally excluded from the tax base.

Before proceeding with the chronology it is important to note that the basic formula finally enacted, *apart from the Exceptions*, is identical with the House bill as to the tax resulting from the inclusion of state and local government bond interest in the computations. (This is conceded, Pet. Br., pp. 67-71). Therefore the Senate discussions of the objections

to the House bill all apply to the basic formula finally enacted, except as those objections were met by the Exceptions.

When the matter came to the Senate controversy arose on the House add-back provision. It produced a result under which a life insurance company could pay a higher tax solely as a result of its receipt of state and local government bond interest (R. 51). This could come about by the investment in state or municipal bonds of cash awaiting investment, or by the sale or maturity of low interest rate state or local government bonds and the reinvestment of the proceeds in the same type of bonds bearing a higher interest rate. To us, a greater quantity of "fully tax exempt" income should produce no more tax than a lesser amount of the same type of income; or than no income at all on the capital represented.

State and local public officials, on the basis of these comparisons, concluded that the House bill offended the requirement for a full and intact constitutional immunity and statutory exemption from federal income taxation of state and local government bond interest. They took their case to the Senate Finance Committee, the record of whose hearings includes some of the considerable opposition which the House bill engendered.

The American Municipal Association (now the National League of Cities), one of your amici, which represents 13,000 municipal governments, submitted a statement in which the House bill was characterized as "* * * the opening wedge to apply the same principle to all other taxpayers." That statement also noted the "* * * higher interest rates which State and local governments would have to pay if such a Federal tax were imposed on all their bonds in the future."[1]

Another of your amici, the National Association of Counties, which represents 6000 counties, endorsed this statement.[2] Other protests are recorded directly[3] or are

---

[1] Hearings, p. 699.

[2] Hearings, pp. 699, 700.

[3] Hearings, p. 593.

reflected in Senator Butler's reference to "the many statements the Finance Committee has received from municipal groups warning of the grave danger this proposal holds in store for them."[1]

The Chairman of the Conference on State Defense, another of your amici, opposed the add-back in the House bill solely on policy grounds.[2] On April 8, 1959 after the Senate Finance Committee Hearings had closed, but as the deliberations of that Committee were proceeding, he filed a formal supplemental statement asserting the unconstitutionality of the add-back in the House bill and adding:

> "A further and compelling reason for amending Sections 805(e) and 809(f) to avoid the add back 'adjustment' for state and municipal bond interest is that the theory of 'double deduction' has not been applied by Congress in other situations where taxpayers might be subjected to the penalties of a similar approach. * * * The bank which pays interest on savings accounts is not required to add back any portion of its income from municipal bonds on the theory that interest paid to depositors should be similarly allocated."

Another example of the traditional meaning of the immunity and exemption of state and local government bond interest was pointed out in that statement to the Senate Finance Committee as follows:

> "The individual who has made charitable contributions is not required to add back any portion of his income from municipal bonds on the theory that the contribution should be allocated between taxable and tax-exempt income."

The statement went on to say:

> "* * * Such an approach in the case of individual banks or other taxpayers similarly situated would

---

[1] Hearings, p. 701.

[2] Hearings, pp. 121-2. See footnote 1, p. 11, supra.

> obviously whittle away at the inherent benefit which the constitutional immunity is intended to afford state and local governments."

State and local governments were not alone in terming the House bill a tax on state and local government bonds. In the Senate Hearings, Senator Talmadge was questioning Mr. Carrol M. Shanks, President of Prudential Insurance Company of America.[1] Senator Talmadge said:

> "Mr. Shanks, I would like to ask you about one matter you didn't testify about. It is one that has been brought up by others, and that is the provision for taxation of tax-exempt bonds.
>
> "Is it your opinion under the terms of the act which we are asking to report to the Senate, tax-exempt obligations would be taxable?"

Mr. Shanks replied:

> "It is my opinion that we would get only a proportionate amount of the tax exemption. Therefore, to that extent I suppose you might say they are taxable."

Senator Talmadge pursued the question of the impact of the provision and the following colloquy took place:

> "Mr. Shanks. There is no question but what, if you take away part of the tax exemption, it makes them less desirable because probably their main appeal is their tax exemption.
>
> "Senator Talmadge. You think, then, that that might result in increased interest rates for tax-exempt obligations in municipalities, counties, and States?
>
> "Mr. Shanks. Well, I don't know how much of an impact the insurance buying would have, but to the extent that it had an impact, it would make the bonds harder to sell, and you would have to pay a higher interest rate."

---

[1] Hearings, pp. 105-6.

Then Senator Talmadge suggested the possibility of amendment "to clarify the exempt status". Mr. Shanks replied:

> "Well, I haven't prepared myself to testify on it. I don't think it would affect our company very much, but I understand that a number of people are going to testify on it, but certainly if they are tax exempt with other industries and other companies, they ought to be tax exempt with the insurance companies."

Other examples, considered by the Senate Finance Committee, of ways in which the House bill would have taxed income immune from taxation were developed in connection with the testimony of other life insurance company representatives.[1]

Of particular importance is the statement placed in the record by Senator Butler,[2] since it is identified by the Petitioner (Pet. Br., p. 76) as "a reason for adding" the Exceptions. Senator Butler opposed the House bill for four independent reasons: because it "taxes tax-exempt interest, is unconstitutional, discriminatory and would have a serious and adverse effect on the State and municipal bond market."[3]

Petitioner's explanation of the Exceptions as designed solely to foreclose a particular constitutional challenge meets only part of one of Senator Butler's four points. It does not meet his objection to taxing tax-exempt interest, to discrimination and to adverse market effect. It does not even meet in full his objection of unconstitutionality.

It is certainly true that Senator Butler believed that the Treasury was seeking to "strike down the whole tax exempt doctrine."[4] That fear, both sides now agree, was dispelled

---

[1] Hearings, pp. 187-8, 252, 305, 405, 687.

[2] Hearings, pp. 700-2.

[3] Hearings, p. 701.

[4] Hearings, p. 702.

by the Exceptions. But Senator Butler was also unequivocal in seeking to overturn "the Treasury stand" because, among other reasons, "In *National Life Insurance Co.* v. *United States* (277 U. S. 508 (1928)) and in *Missouri* v. *Gehner* (281 U. S. 313 (1930)) the Court in the plainest and most emphatic language has characterized formulas as contained in H. R. 4245 as unconstitutional. Despite more recent decisions on collateral questions these decisions remain unmodified and unchallenged. As such they are the only appropriate guide posts in considering this vital question of constitutionality."

Under questioning by Senator Butler, the Assistant to the Secretary of the Treasury defended the House bill but not on the ground that the House formula avoids the imposition of a tax on state and local government bond interest. First, Senator Butler asked:[1]

> "When you speak of a deduction to avoid a double benefit, you are in reality saying that you are charging a part of the operating expense against tax-free interest?"

And the Assistant, Mr. Lindsay, replied:

> "Yes, I think that is probably a fair statement."

And then Senator Butler asked:

> "Why do you tax that interest even partially?"

And Mr. Lindsay's answer was:

> "Because we think it is right."

The Treasury thereby conceded the partial taxation which state and local government officers were protesting, and of which they sought correction in the Senate Finance Committee.

---

[1] Hearings, p. 43.

It was with this background that the Senate Finance Committee proceeded with its deliberations. Within the subject matter of this law suit, two major changes emerged and were reported to the Senate. The first was a change in language as to the basic formula, and the second was the addition of the critical Exception provisions.

In re-casting the basic formula, the Senate Finance Committee attributed a portion of the life insurance company's income and exemption to the policy holders who are the principal creditors of the company. This approach eliminated the *words* appearing in the offensive add-back provision in the House bill, but the significant fact is that it did not change by so much as a penny the *tax result* of the House bill, including the add-back provision (R. 49, 51). This is conceded by Petitioner (Pet. Br., pp. 67-71).

The new wording did not therefore answer the complaints of the Senators quoted and of state and local government officers that the market for their bonds would be adversely affected, that a portion of their benefit from the traditional exemption and immunity was being destroyed and that aside from the practical consequences of that destruction, it raised the danger of a new constitutional controversy in the field of inter-governmental relations. It did not answer the objections that the bill was unfairly discriminatory as between taxpayers. It did not answer the objections of Senator Talmadge who had bluntly told the principal Treasury witness that the Act should "make it uniform" for all classes of taxpayers, and that the economic effect of the House bill on the States and local governments rendered the bill not only undesirable, but unconstitutional. Senator Talmadge stated:

> "It would be a very important thing not only to insurance companies but to counties, States, and municipalities that build hospitals, school buildings, and things of that type, if they suddenly found their interest rate raised to the degree of maybe three-quarters of 1 percent. This being true when trying to be competitive in the market when selling their obligations. This is important not only to the insur-

ance companies and the taxpayer, but it is of vast importance also to those subdivisions of State governments in States at the present time which have tax-exempt status.

> "I think we ought to make it uniform if we are going to attempt it, and I don't think we can constitutionally, under the present law, tax obligations of States, counties and municipalities. I certainly think we ought to make it uniform and operate it in the same way with reference to an individual taxpayer, a bank, a casualty company, and others, as we would to an insurance company." (Hearings, pp. 47-48).

Obviously, it was the second change which the Senate Finance Committee introduced which alone dealt with these problems: the addition of the two Exception provisions.

Chairman Byrd of the Senate Finance Committee reported this amended bill to the Senate with a detailed statement, advising that it avoided any tax on state and local government bond interest (105 Cong. Rec. 8401).[1] The Treasury contribution before the Senate was opposition to the Exception provisions proposed by the Finance committee. In a letter addressed to Senator Byrd, Committee Chairman, on May 18, 1959, from the Assistant to the Secretary, which appeared in the Congressional Record of May 19, 1959, it was stated for the Treasury:

> "In our opinion, this additional language is not necessary, since we cannot envision a situation in which the operation of the proposed tax formula would result in the substantive imposition of tax on municipal bond interest or on any other form of tax-exempt income." (105 Cong. Rec. 8402)

This objection was swept aside.

---

[1] We find no evidence to support Petitioner's statement (p. 65) that it was Senator Curtis, a junior Committee member of the minority party, "who was chosen [by the Committee?] to explain the Committee bill to the Senate." A similar statement was made below by the Petitioner (then Respondent), was not questioned by the taxpayer or by us and appeared in the opinion below.

And so, the Senate adopted amendments which not only re-cast the House basic formula, but required adjustment of the results thereof under the Exception provisions.

The matter then went to conference between the House and the Senate. While the Record, of course, does not show it, state and local government officers, including many of your amici, then addressed their petitions and arguments to the House conferees to support the Senate version.

Our arguments were not arguments indicating a semantic preference for one phrasing over another. Our arguments related to the actualities of the tax penalties and burdens on state and local governments which the basic formula produced (in both the House version or under the Senate formula before adjustment under the Exception provisions) solely because of the receipt of state and local government bond interest. In opposition to the Treasury's assertion that the Exceptions were "not necessary," we urged the House conferees to yield and accept the Exception provisions in order to achieve a *practical* result in having that full measure of the traditional exemption and immunity and that full measure of benefit to state and local governments resulting therefrom which we have outlined in Points I and II.

The House conferees recommended to the House that it yield to the Senate and accept the Exception provisions. (Report No. 520, 86th Cong., p. 15.) The House agreed, and when the matter was reported to the Senate for action on the final conference report, the matter was again presented by Chairman Byrd of the Senate Finance Committee. He said (105 Cong. Rec. 10400):

> "I am glad to report to the Senate that the House conferees accepted the Senate amendment relating to tax-exempt interest. This amendment provided that if it is established in any case that the application of the definition of taxable investment income results in the imposition of the tax on any tax-exempt interest * * * adjustment shall be made to prevent such imposition."

Senator Thurmond then asked:

> "* * *. As I understand from the report, county and municipal bonds will not be taxed under the bill. Is that correct? Is that the Senator's construction?"

The Senate Finance Committee Chairman answered:

> "That is my construction. There is a proviso that if by any chance under the bill they will be taxed, necessary steps will be taken to refund the tax.
>
> "Mr. Thurmond. I thank the Senator.
>
> "Mr. Byrd. That provision was not changed in conference.
>
> "Mr. Thurmond. I thank the distinguished Senator for furnishing that information. I was vitally interested in it. I believe it means a great deal to the people of our Nation to preserve our State and municipal bonds untaxed by the Federal Government.
>
> "Mr. Byrd. I agree with the Senator from South Carolina."

It will be noted that the Senate Finance Committee Chairman spoke of "necessary steps * * * to refund the tax." That is the nature of the present action.

It will also be noted that the two Senators agreed that "it means a great deal to the people of our Nation to preserve our State and municipal bonds untaxed by the Federal Government." Obviously, it means nothing beneficial in this context to "preserve our State and municipal bonds untaxed" by producing the tax result contended for by the Treasury in this case and merely labelling it something other than a tax on state and local government bond interest.

It would be a crass charge to suggest that in the foregoing colloquy Senator Byrd disingenuously had his tongue in his cheek and meant that the bill he had worked for, with the new Exception provisions, still authorized the taxation of the holders of state and municipal bonds solely because of their receipt of interest on those bonds, and that the conferees harbored a secret and unexpressed rationalization

that this did not constitute a tax "on" that interest. The questions asked by Senator Thurmond and answered by Senator Byrd were the result of state and local government protests and Senators' opposition as to the *pragmatic* effect of the House bill. They could *not* be answered solely by re-casting the House bill into a different "device or form of words" with the identical practical result. Other Senators who heard this debate, without the Committee's detailed knowledge of the intricacies of the taxing formula, could not for a moment have believed that they were voting for a measure which increased a tax solely because of the receipt of interest on municipal bonds.[1]

Petitioner nevertheless contends that this "is self-contradiction," pointing out that in the Tenth Circuit view some of the result of the basic formula is undone by the Exception provisions, and concludes that "no rational body would consciously set out to accomplish that result by

---

[1] Compare *Sinclair Refining Company* v. *Atkinson*, 370 U. S. 195, 209 (1962), in which the Court said:

> "The unequivocal statements in the House Conference Report and by Senator Taft on the floor of the Senate could only have been accepted by the Congressmen and Senators who read or heard them as assurances that they could vote in favor of § 301 without altering, reducing or impairing in any manner the anti-injunction provisions of the Norris-LaGuardia Act. This is particularly true of the statement of Senator Taft, a man generally regarded in the Senate as a very able lawyer and one upon whom the Senate could rely for accurate, forthright explanations of legislation with which he was connected. Senator Taft was of course entirely familiar with the prohibitions of the Norris-LaGuardia Act and the impact those prohibitions would have upon the enforcement under § 301 of all related contractual provisions, including contractual provisions dealing with arbitration. If, as this argument suggests, the intention of Congress in enacting § 301 was to clear the way for judicial obliteration of that Act under the soft euphemism of 'accommodation', Senator Taft's flat statement that the Conference had rejected the repeal of the Norris-LaGuardia Act *could only be regarded as disingenuous. We cannot impute any such intention to him.*" (Italics added.)

repealing in one provision what it enacted in another." (Pet. Br., p. 57).

We do not understand this objection. Draftsmen frequently use provisos to limit a generalization which has gone too far. An Exception provision, as its name indicates, can have no other purpose—according to Webster an exception is a "restriction which would otherwise be included."

But here there is still another consideration which is consistent with complete rationality on Congress' part. Congress consists not of one but of two Houses. When the Senate Finance Committee came to the conclusion that it would meet the objections voiced by its members and by a host of state and local governments, it was faced with the fact that its views could not prevail unless the House yielded. How the amendment would be cast might well strengthen or weaken the chances of procuring House acquiescence. Was it not more likely that the change could be "sold" to the House in a form which retained the House formula in effect if not in words and then attached exceptions?

The process of compromise between two Houses, as between the members of a single legislative body or even a pair of attorneys working up a contract between their respective clients, may well produce a final document which would be different in form if the process of accommodation were not necessary. This does not prove either irrationality or self-contradiction. In a metaphoric sense a bicameral legislature will often have a "split personality" without inviting the Petitioner's diagnosis of "schizophrenia." (Pet. Br., p. 59).

The legislative history shows that Petitioner's interpretation of the Exceptions is untenable. The Congress should not thus be charged with being "disingenuous." (Cf. *Sinclair Refining*, supra.). It preserved the full and traditional exemption and immunity of state and local government bond interest for life insurance companies on a parity with all other investors in state and local government bonds, without any erosion by proration.

POINT IV

The necessity of giving meaning to the Exception provisions.

The Treasury Department argued to the Senate that the Exception provisions were "not necessary" (105 Cong. Rec. 8402). This was an understandable argument in a lobbying effort to beat the proposed Exception provisions. But it became an impossible interpretation once Congress rejected the Treasury Department view and enacted the provisions.[1]

And yet the Petitioner still argues that "the 'exception' clause might well have been omitted." (Pet. Br., p. 76), thus concluding a point whose caption states "the 'exception clauses' are inoperative." (Pet. Br., p. 52).

In Petitioner's view an adjustment will never be made under the Exception provisions: they are "inoperative." To Petitioner the Act produces exactly the same tax consequences to Respondent or any other taxpayer as if the Exception provisions had never been enacted: they "might well have been omitted."

Yet no part of a statute can be interpreted as nugatory if the Court can possibly give it effect. As stated in *United States* v. *Menasche*, 348 U. S. 528, 538-39 (1955):

> "* * * 'The cardinal principle of statutory construction is to save and not to destroy.' National Labor Relations Board *v.* Jones & Laughlin Steel Corp., 301 U. S. 1, 30. It is our duty 'to give effect,

[1] When Chairman Byrd reported the Finance Committee Bill to the Senate, he said "The Treasury has assured the committee that this formula does not impose any tax on tax-exempt interest." But apparently these Treasury assurances were not enough because the Chairman went on in his next sentence to say "The bill adds a proviso to the effect that if the formula I have described does result in the imposition of tax on this item, the formula is to be adjusted so that it does not do so." (105 Cong. Rec. 8401).

> if possible, to every clause and word of a statute,' Inhabitants of Montclair Tp. *v.* Ramsdell, 107 U. S. 147, 152, rather than to emasculate an entire section, as the Government's interpretation requires."

Petitioner suggests that the Tenth Circuit interpretation is faulty because, Petitioner says, "the exception clause comes into play to the same extent, if at all, in every case in which the company receives State-bond interest" (Pet. Br., p. 56, fn. 24) and adjustment will "always" be made (p. 57).

If this were so, it would still not be an objection to the Tenth Circuit position. Where there is a rule and an "exception" the "exception" must prevail even if it completely displaces the rule. But the Petitioner is wrong in concluding that in the Tenth Circuit view the Exceptions will "always" require an adjustment if the company receives state or local government bond interest. The adjustment would be made if and only if exclusion of the interest from the computation would produce a lower tax result than inclusion of the interest. And this is not always the case, as even Petitioner implies.[1]

For example, Respondent's brief shows that it would not be so in the case of a company with an investment yield of under $250,000 and with a low ratio of reserves to assets, for which the small business deduction may be larger

---

[1] Footnote 7 on page 20 of Petitioner's Brief qualifies the text statement on that page that in computing "gain from operations" "the receipt of an increment of tax-exempt income, all other things being equal, will necessarily increase the amount of taxable income the company has after additions to the reserve, and will thus increase its total tax." The footnote says that this "result will *normally* occur also under the definition of 'taxable investment income' but whether it will *necessarily* occur depends upon what assumptions are made * * *." (Italics the Petitioner's). The qualification has substantial application since the Senate Finance Committee Report estimated that 92% of the total estimated tax receipts would be derived under Phase I, which is "taxable investment income." (Sen. Rep. 291, 86th Cong. 1st Sess., p. 12)

than the increase in the taxable items of investment income taxed to the company which results when the larger "investment yield" is used to determine the "policyholders' share" exclusion.[1]

Another example would occur if the five year "average earnings rate" is lower than the "current earnings rate" as a result of a drop in the extent of state and local government bond interest received. Many factors could cause such a drop. The granting of certiorari in this proceeding might have induced some companies to reduce their investment in state and local bonds. A drop in interest rates of municipals relative to corporates (such as happened in the 1940's) could produce the same result by inducing insurance companies to switch to taxable bonds. A drop in corporate tax rates which would make the exemption less valuable is a third possibility. A fourth would be the growth of a company in size and investments during the five year period without increasing proportionately its investments in state and local government bonds.[2]

That the tax would sometimes increase if state and local government bond interest were always excluded from the computation was confirmed by the same David Lindsay who had testified for the Treasury in the Senate Finance Committee on the House bill. After he had become General Counsel of the Treasury Department, in a letter dated November 27, 1959 to the Secretary of the Conference on State Defense, one of the signatories of this brief, Mr. Lindsay said that under such circumstances

> "A company which has proportionately higher investments in municipals (or in stocks) in any one

---

[1] In fact there were such companies in the period 1960-3. The National Underwriter, March 6, 1965, p. 22.

[2] Actually the industry as a whole has revealed such a trend. The percentage of total assets invested in state and local government bonds was 6.8% in 1940 but only 2.7% in 1963. 1964 Life Insurance Company Fact Book, pp. 65, 73.

> or more of the four years preceding the taxable year than in the taxable year would pay a higher tax than an identical company which did not have corresponding investments in municipals in any of the four years preceding the taxable year."

These are examples of cases in which adjustment would *not* be made because the basic formula cannot be said to result in the imposition of tax on state and local bond interest if its inclusion produces a lower tax result than its exclusion.

This is important when we look at the exact language of the Exceptions. They do not provide for an adjustment in every situation and they certainly do not provide, as Petitioner contends, that the adjustment shall never be made. What they say is that the adjustment shall be made "If it is established in any case" that the formula results in the imposition of the prohibited tax. The Respondent has made the showing which entitles it to the adjustment for the year in question. Other companies in particular years may not be able to make that showing. But the test adopted by the Tenth Circuit is one which fits the language of the statute, while Petitioner's view flagrantly fails to do so.

Nevertheless, Petitioner claims to illustrate "The bizarre implications of imputing to Congress a purpose to adopt its own independent standard of what a tax is 'on' " (Pet. Br., pp. 56-7), as if self-contained legislation is unthinkable. This is the obverse of Petitioner's claim that the only acceptable standard to determine whether adjustment shall be made under the Exceptions is "some external standard" (p. 55). The Petitioner then claims Congress intended "some superior external standard with which the courts were more familiar than the Congress" (p. 56). In other words, Petitioner concludes that Congress delegated to the courts the completion of the legislative process.

Such a view comes suspiciously close to offending the doctrine of separation of powers. In any event it con-

tradicts the Court's view of its function as illustrated in *Sinclair Refining Co.* v. *Atkinson*, 370 U. S. 195 (1962). There, the Court said (p. 209):

> "We cannot accept the startling argument made here that even though Congress did not itself want to repeal the Norris-LaGuardia Act, it was willing to confer a power upon the courts to 'accommodate' that Act out of existence whenever they might find it expedient to do so in furtherance of some policy they had fashioned under § 301."

The Court refused to impute to Congress an intention "to clear the way for judicial obliteration of that Act under the soft euphemism of 'accommodation' * * *." In rejecting an argument very closely parallel to Petitioner's here, the Court said (370 U. S. at 209-10):

> "Moreover, we think that the idea that § 301 sanctions piecemeal judicial repeal of the Norris-LaGuardia Act requires acceptance of a wholly unrealistic view of the manner in which Congress handles its business. The question of whether existing statutes should be continued in force or repealed is, under our system of government, one which is wholly within the domain of Congress. When the repeal of a highly significant law is urged upon that body and that repeal is rejected after careful consideration and discussion, the normal expectation is that courts will be faithful to their trust and abide by that decision. This is especially so where the fact that the controversy over repeal and the resolution of that controversy in Congress plainly appears in the formal legislative history of its proceedings."

If for "the soft euphemism of 'accommodation'" we substitute "the soft euphemism of 'proration'," and if for the proposed "judicial repeal of the Norris-LaGuardia Act" we read the proposed "judicial repeal of the essence, if not the form, of the exemption of state and local government bond interest," and if for "§ 301" we read "the Exception provisions," we have in the foregoing opinion a

complete rejection of the Petitioner's final effort to give some meaning to the Exception provisions while keeping them "inoperative."

It may be that Petitioner means to treat the Exception provisions as being merely "separability provisions" and as having no other effect. The difficulty with this view is that the Code contains an outright separability clause, § 7852 (a), so that there was no occasion for another. Moreover, as Petitioner acknowledges (Pet. Br., p. 76), "the courts presumably would not need statutory authority to adjust the tax" if they found the formula unconstitutional. For this reason also it is not possible to restrict the Exception provisions to the meager role to which the Petitioner consigns them.

Besides, the Treasury Regulation on the subject leaves it not only to the courts but "to the satisfaction of the Commissioner" of Internal Revenue to determine whether to make the adjustments directed by the Exception provisions (Reg. § 1.804-2(f) and § 1.809-3(d)). This contradicts the Petitioner's present theory that only the courts may adjust and then only if they find the basic formula unconstitutional. It suggests that the Petitioner's present theory is an afterthought, *ad litem*, rather than a sound statement of actual Congressional intent in 1959.

To achieve rationality, the Petitioner need only take the final step from the Regulations and recognize that the Exceptions, like all the provisions of the basic formula, are directed in the first instance not to the Commissioner or the courts, but to each individual taxpayer. The Exceptions do not, as Petitioner claims, invite unvarying judicial application of the formula which they authorize to be adjusted. Rather they lay down a rule by which each company can make an adjustment "if it is established in any case" (i.e., the case of a particular tax return for a particular tax year) that the unadjusted formula "results" in a tax on its state and local government bond interest by increasing the company's otherwise tax liability solely as a result of the receipt of the interest.

CONCLUSION

For the reasons stated, the judgment of the Court of Appeals for the Tenth Circuit should be affirmed.

Respectfully submitted,

GRANT SAWYER, Governor of Nevada and Chairman of the *Governors' Conference*

LOUIS L. GOLDSTEIN, Comptroller of Maryland and Chairman of Committee on Taxation of State Bonds of the *National Association of State Auditors, Comptrollers and Treasurers*

JEROME CAVANAGH, Mayor of Detroit and Vice President of the *National League of Cities*

C. BEVERLY BRILEY, County Mayor of the Metropolitan District Government of Nashville — Davidson County, Tennessee and Immediate Past President of the *National Association of Counties*

ROBERT B. MATHIAS, County Counsel of Prince Georges County, Maryland and President of the *National Association of County Civil Attorneys*

C. D. WARD, General Counsel of the *National Association of Counties.*

MITCHELL WENDELL, Counsel to the *Council of State Governments*

JACK P. F. GREMILLION, Attorney General of Louisiana and President of the *National Association of Attorneys General*

JOHN J. O'CONNELL, Attorney General of Washington and Immediate Past President of the *National Association of Attorneys General*

JOHN J. GUNTHER, General Counsel of the *United States Conference of Mayors*

JOHN J. FLEMING, City Attorney of Milwaukee, Wisconsin and President of the *National Institute of Municipal Law Officers*

CHARLES S. RHYNE, General Counsel of the *National Institute of Municipal Law Officers*

DANIEL B. GOLDBERG, General Solicitor of The Port of New York Authority, Counsel for the *Municipal Finance Officers Association* and Secretary of the *Conference on State Defense*

111 Eighth Avenue,
New York, N. Y. 10011.

Amici Curiae

With them on the brief:

CHARLES E. NORMAN,
City Attorney, Tulsa, Oklahoma.

MICHAEL S. ZAKIN,
Attorney, The Port of New York Authority.

March, 1965.

LIBRARY
SUPREME COURT, U. S.

Office-Supreme Court, U.S.
FILED
MAR 17 1965
JOHN F. DAVIS, CLERK

IN THE

Supreme Court of the United States

OCTOBER TERM, 1964

No. 489

UNITED STATES OF AMERICA,
Petitioner,

v.

ATLAS LIFE INSURANCE COMPANY,
Respondent.

BRIEF OF RESPONDENT

NORRIS DARRELL
Attorney for Respondent
48 Wall Street
New York, New York 10005

M. BERNARD ADINOFF
KENDYL K. MONROE
SULLIVAN & CROMWELL

DICKSON M. SAUNDERS
DOERNER, STUART, MORELAND
& SAUNDERS

BYRON V. BOONE
BOONE & ELLISON

THOMAS C. THOMPSON, JR.
SCRIBNER, HALL & CASEY
Of Counsel.

INDEX

	PAGE
Question Presented	1
Statutes Involved	2
Statement	3
Summary of Argument	7
Argument	
I. Sections 804(a)(6) and 809(b)(4) Apply Where an Increase in Tax Would Result From the Inclusion of State and Municipal Bond Interest in the Tax Computation of a Life Insurance Company	10
A. Tax Legislation and Judicial Decisions Prior to the 1959 Act	10
B. Legislative History of the 1959 Act	15
II. Petitioner's Apportionment Argument Disregards the Traditional Immunity of State and Local Government Obligations From Federal Income Taxation and Raises Constitutional Questions That This Court Should Avoid	31
A. The *National Life* Decision Must Be Followed	34
B. Petitioner's Concept of the Immunity of State and Municipal Bond Interest From Federal Income Taxation Is Not Supported by the Authorities and Examples Cited in Its Brief	45
C. Petitioner's Interpretation of Sections 804(a)(6) and 809(b)(4) Is Contrary to the Language of Those Sections	51
Conclusion	57
Appendix A	59
Appendix B	64

CITATIONS

Cases:

	PAGE
Ashwander v. *Tennessee Valley Authority*, 297 U.S. 288 (1936)	34
Burnet v. *Wells*, 289 U.S. 670 (1933)	50
Corliss v. *Bowers*, 281 U.S. 376 (1930)	50
Crowell v. *Benson*, 285 U.S. 22 (1932)	34
Denman v. *Slayton*, 282 U.S. 514 (1931)	13, 14, 34, 45, 46, 47, 48
Eisner v. *Macomber*, 252 U.S. 189 (1920)	35, 36, 37, 38
Hale v. *Iowa State Board*, 302 U.S. 95 (1937)	32
Helvering v. *Gerhardt*, 304 U.S. 405 (1938)	32
Helvering v. *Griffiths*, 318 U.S. 371 (1943)	35, 36, 37, 38, 39
Helvering v. *Independent Life Ins. Co.*, 292 U.S. 371 (1934)	14, 45, 47, 48
Miller v. *Milwaukee*, 272 U.S. 713 (1927)	40, 41, 42
Missouri ex rel. *Missouri Ins. Co.* v. *Gehner*, 281 U.S. 313 (1930)	7, 13, 20, 21, 22, 34, 41, 42, 47, 48
National Life Ins. Co. v. *United States*, 277 U.S. 508 (1928)	3, 4, 7, 8, 9, 11, 12, 13, 14, 20, 21, 22, 24, 29, 34, 35, 36, 37, 38, 39, 40, 41, 42, 45, 46, 47, 48, 57
New Jersey Realty Title Ins. Co. v. *Division of Tax Appeals*, 338 U.S. 665 (1950)	43, 44
Northwestern Mut. Life Ins. Co. v. *Wisconsin*, 275 U.S. 136 (1927)	40, 42
Packard Motor Car Co. v. *City of Detroit*, 232 Mich. 245, 205 N.W. 106 (1925)	13, 39, 40
Pollock v. *Farmer's Loan & Trust Co.*, 158 U.S. 601 (1895)	32

PAGE

Reinecke v. *Smith*, 289 U.S. 172 (1933) 50

Rosenberg v. *Fleuti*, 374 U.S. 449 (1963) 34

Sinclair Ref. Co. v. *Atkinson*, 370 U.S. 195 (1962) 38

Statutes:

Internal Revenue Code of 1954, as amended, 26 U.S.C. (Supp. V 1959-64):

Section 103 ..... 11, 52, 53

Section 242 51

Section 243 51

Section 244 51

Section 245 51

Section 802(a) 59, 76

Section 802(a)(1) 63

Section 802(a)(2) 63

Section 802(b) 59, 76

Section 802(b)(1) 63

Section 802(b)(2) 63

Section 804(a)(1) 53, 59, 60, 70

Section 804(a)(2) 59, 61, 70, 71, 72

Section 804(a)(2)(A)(i) 53, 71

Section 804(a)(4) 55

Section 804(a)(6) 1, 2, 5, 7, 9, 10, 17, 33, 34, 51, 55, 57, 61, 76

Section 804(b) 59

Section 804(c) 49, 52, 59, 68, 73

Section 804(c)(3) 48

Section 805 ..... 53, 60

Section 805(a) 60, 69

PAGE

Section 805(b) ---- 60
Section 805(b)(1) ---- 69
Section 805(b)(2) ---- 68
Section 805(b)(3) ---- 68
Section 805(c) ---- 60, 69
Section 805(e) ---- 17
Section 809 ---- 62
Section 809(a)(1) ---- 53, 62, 73
Section 809(a)(2) ---- 62, 73
Section 809(b)(1) ---- 62, 74
Section 809(b)(3) ---- 62, 73
Section 809(b)(4) ---- 1, 2, 3, 5, 7, 9, 10, 17, 33, 34, 51, 55, 57, 63, 76
Section 809(d) ---- 62
Section 809(d)(10) ---- 55
Section 809(d)(12) ---- 48
Section 809(f) ---- 17, 63
Section 809(f)(1) ---- 17
Section 809(d)(8)(A)(i) ---- 53, 74
Section 810(a) ---- 62
Section 810(b) ---- 62
Section 815 ---- 63
Section 815(b)(2)(A)(iii) ---- 50

Revenue Act of 1921, ch. 136, 42 Stat. 238, 261:
Section 213(b)(4) ---- 11
Section 245(a)(2) ---- 11

Revenue Act of 1932, ch. 209, 47 Stat. 224:
Section 203(a)(2) ---- 12

Revenue Act of 1942, ch. 619, 56 Stat. 870:
Section 163 ---- 15

Revised Statutes of the United States, Section 3701, now 31 U.S.C. § 742 (Supp. IV 1963) 43

Pub. L. No. 86-346, 73 Stat. 622 (1959) ---- 43

PAGE

Miscellaneous:

50 Cong. Rec. 508 ---- 42

65 Cong. Rec. 7668 ---- 47

105 Cong. Rec. 8401 ---- 26

105 Cong. Rec. 8402 ---- 24, 26

105 Cong. Rec. 8429 ---- 25

105 Cong. Rec. 10400 ---- 28

105 Cong. Rec. 10413 ---- 27

105 Cong. Rec. 10414 ---- 27

Compendium of Papers on Broadening the Tax Base Submitted to the House Ways and Means Committee, 86th Cong., 1st Sess. (1959) ---- 36, 51

Hearings Before the House Ways and Means Committee on Revenue Revision of 1942, 77th Cong., 2d Sess. (1942) ---- 14

Hearings Before the Senate Finance Committee on H.R. 10236, 72nd Cong., 1st Sess. (1932) ---- 12

Hearings Before the Senate Finance Committee on H.R. 7378, 77th Cong., 2d Sess. (1942) ---- 14

Hearings Before the Senate Finance Committee on H.R. 4245, 86th Cong., 1st Sess. (1959) ---- 17, 19, 20, 21, 22

H.R. Rep. No. 520, 86th Cong., 1st Sess. (1959) 27

H.R. 4245, 86th Cong., 1st Sess., §§ 805(e), 809(f)(1) ---- 17

Institute of Life Insurance, *Life Insurance Fact Book 1964* ---- 56

PAGE

Panel Discussions on Revision of the Federal Income Tax Structure Before the House Ways and Means Committee, 86th Cong., 1st Sess. (1959) ---------- 36

Report on the Taxation of Income of Life Insurance Companies by the Subcommittee on Internal Revenue Taxation of the House Ways and Means Committee, 85th Cong., 2d Sess. (1958) ---------- 15, 16

S. Rep. No. 52, 69th Cong., 1st Sess. (1926) -- 47

S. Rep. No. 291, 86th Cong., 1st Sess. (1959) ---------- 17, 23, 24

S. Rep. No. 909, 86th Cong., 1st Sess. (1959) - 43

Subcommittee on the Taxation of Life Insurance Companies of the House Ways and Means Committee, A Preliminary Statement of Facts and Issues With Respect to the Federal Taxation of Life Insurance Companies, 83rd Cong., 2d Sess. (1954) -- 11, 16

The National Underwriter, March 6, 1965 --- 55, 56

T.D. 4231, VII-2 Cum. Bull. 299, 300 (1928) - 12

Treasury Regulations, 26 C.F.R., Part 1:
Section 1.804-3(a)(1)(i) ---------- 52
Section 1.804-4(b)(1)(ii) ---------- 49
Section 1.815-3(d) ---------- 50

IN THE

Supreme Court of the United States

OCTOBER TERM, 1964

No. 489

UNITED STATES OF AMERICA,
Petitioner,

v.

ATLAS LIFE INSURANCE COMPANY,
Respondent.

BRIEF OF RESPONDENT

Question Presented

In Sections 804(a)(6) and 809(b)(4) of the Internal Revenue Code, Congress provided that if in any case the application of the statutory formulae for taxing life insurance companies "results in the imposition of tax on" state and municipal bond interest, adjustments "shall be made to the extent necessary to prevent such imposition." It is conceded that respondent's Federal income tax liability determined without making any adjustments under Sections 804(a)(6) and 809(b)(4) would be increased solely because of the receipt of interest on state and municipal bonds. The question presented is whether in enacting these sections Congress intended to eliminate any such increase in

a life insurance company's tax liability so as to preserve the traditional immunity of state and local bond interest from Federal taxation and to avoid placing an economic burden on the receipt of such interest.

If this was the intent of Congress, as the Court of Appeals held, there is no further question as to the meaning of Sections 804(a)(6) and 809(b)(4), and no constitutional question can arise as to the scope of the immunity of state and municipal bond interest from Federal taxation.

Statutes Involved

Internal Revenue Code of 1954, as amended by the Life Insurance Company Income Tax Act of 1959, § 2, 73 Stat. 112, 26 U.S.C. (Supp. V, 1959-64).

"SEC. 804. TAXABLE INVESTMENT INCOME.

"(a) IN GENERAL.—

* * * * *

"(6) EXCEPTION.—If it is established in any case that the application of the definition of taxable investment income contained in paragraph (2) results in the imposition of tax on—

"(A) any interest which under section 103 is excluded from gross income,

"(B) any amount of interest which under section 242 (as modified by paragraph (3)) is allowable as a deduction, or

"(C) any amount of dividends received which under sections 243, 244, and 245 (as modified by paragraph (5)) is allowable as a deduction,

adjustment shall be made to the extent necessary to prevent such imposition."

* * * * *

"SEC. 809. IN GENERAL.

* * * * *

"(b) GAIN AND LOSS FROM OPERATIONS.—

* * * * *

"(4) EXCEPTION.—If it is established in any case that the application of the definition of gain from operations contained in paragraph (1) results in the imposition of tax on—

"(A) any interest which under section 103 is excluded from gross income,

"(B) any amount of interest which under section 242 (as modified by section 804(a)(3)) is allowable as a deduction, or

"(C) any amount of dividends received which under sections 243, 244, and 245 (as modified by subsection (d)(8)(B)) is allowable as a deduction,

adjustment shall be made to the extent necessary to prevent such imposition."

Statement

Since 1921 the tax laws have provided methods, uniform for all companies, for determining the deduction allowed to life insurance companies in computing their taxable income for the annual increases in reserves necessary to meet policyholders' claims—such increases being the major business expense of life insurance companies.

The Revenue Act of 1921 provided that the deduction should be determined by applying a rate of 4% to each company's reserves; however, the deduction was to be reduced by the amount of state and municipal bond interest received by the company. In *National*

Life Ins. Co. v. United States, 277 U. S. 508 (1928), a decision brought to the attention of Congress when considering the Act here involved, this reduction of the reserve deduction was held to be a tax on state and municipal bond interest which Congress had no power to impose. Congress then deleted the reduction provision from the statute, and since that time Congress has consistently provided a method of taxation for life insurance companies pursuant to which their tax liabilities, like those of all other taxpayers, have not been affected by an individual company's receipt of state and municipal bond interest.

In 1958, when a comprehensive revision in the taxation of life insurance companies was undertaken, the House of Representatives initially passed a bill which provided that the deduction in respect of reserve liability increases would be reduced by that portion of a company's state and municipal bond interest equal to the ratio that the reserve deduction bore to the company's total investment income. This provision was severely criticized when the bill reached the Senate Finance Committee for two distinct, but related, reasons. The marketability of state and municipal bonds would be adversely affected if an economic burden were for the first time placed by the tax laws on the receipt by life insurance companies of interest on such bonds. And the basic immunity of state and municipal bonds from Federal income taxation affirmed in *National Life* and consistently followed by Congress in all subsequent statutes would be upset. Responding to this criticism, the Senate Finance Committee added the

adjustment provisions of Sections 804(a)(6) and 809 (b)(4) to the bill. The subsequent debates in both Houses of Congress on the bill containing the adjustment clauses confirm Congress' understanding that the traditional exemption of state and municipal bond interest would be preserved under the new law even if the basic taxing formula had to be adjusted to accomplish this.

Under the Life Insurance Company Income Tax Act of 1959 as finally enacted, the company's investment income is divided into the "policyholders' share" and the "company's share". Only the "company's share" is included in its taxable income, which is determined principally in two phases, "taxable investment income", which includes only income from investments, and "gain from operations", which includes underwriting income as well as investment income. (If "gain from operations" is larger than "taxable investment income", 50% of the excess is included in "life insurance company taxable income".[1]) The "policyholders' share", although labeled an exclusion from income, is in reality a deduction allowed on account of increases in reserve liabilities needed to meet policyholders' claims. The amount of this exclusion is separately computed by applying certain earnings rates or interest rates to the company's reserve liabilities. Since the total amount excluded from income as the "policyholders' share" is relatively constant, as investment income increases a smaller percentage of

[1] The other 50% of the excess is included in taxable income if and when distributed to shareholders. This is known as the "phase 3" tax base.

investment income is allocable to the "policyholders' share" and a larger percentage is taxable to the company as the "company's share."

A detailed description of the applicable provision of the Life Insurance Company Income Tax Act of 1959 is contained in Appendix A at pp. 59-63.

During the year 1958, respondent received $36,637.79 of state and municipal bond interest. If the definitions contained in the Act were applied without adjustments and this interest were included in the investment income which is divided between the "policyholders' share" and the "company's share", a higher percentage of each and every item of income from investments would be included in the "company's share" and taxed to the company. Although the statutory formula allows a deduction for the amount of state and municipal bond interest included in the "company's share", no deduction is allowed for the increased amount of the taxable items of investment income that would be taxed to the company by reason of the receipt of the state and municipal bond interest. In effect, as is conceded, the exclusion or deduction from taxable income of the amount necessary to satisfy increases in reserve liabilities is reduced by a pro rata portion of state and municipal bond interest. In respondent's case this has the result of increasing its Federal income tax liability by $11,252.19 by reason of its receipt of $36,637.79 of state and municipal bond interest. The marginal rate of taxation on such interest is 29.1%. (R. 45.)

Summary of Argument

In Sections 804(a)(6) and 809(b)(4), Congress provided that adjustments shall be made if the application of the statutory definitions "results in the imposition of tax" on state and municipal bond interest. In providing for such adjustments, Congress was concerned that no economic burden be placed upon the receipt of such interest. The economic effect which Congress understood would not occur after enacting the adjustment clauses plainly would exist if by reason of the receipt of state and municipal bond interest respondent's tax burden would be increased. It is conceded that such an increase would take place in respondent's case. The plain language of Sections 804(a)(6) and 809(b)(4) commands that adjustments be made.

On several occasions since this Court's decision in the *National Life* case, the Treasury Department has sought to find a way to impose a tax on the state and municipal bond interest received by life insurance companies. In each instance, Congress has resisted these attempts and has made it clear that the immunity of state and municipal bond interest from Federal income taxation enjoyed by other taxpayers is to be enjoyed without dilution by life insurance companies consistent with the standards set forth in *National Life* and other similar cases.[2] As the Court of Appeals found (R. 113; 333 F.2d at 398), Congress in enacting Sections 804(a)(6) and 809(b)(4) legislated with an eye to the decision in *National Life*. If the receipt of state and

[2] These include the cases cited with approval in *National Life* and the decision in *Missouri* ex rel. *Missouri Ins. Co.* v. *Gehner*, 281 U. S. 313 (1930), all of which are discussed *infra* at pp. 39-42.

municipal bond interest results in an increase in tax, as it does in the instant case, under *National Life* a tax is imposed on state and municipal bond interest and Congress intended the adjustment clauses to apply.

Petitioner has attempted to justify the operation of the statutory formulae without the adjustment clauses on the ground that a deduction for an expense is merely being allocated between taxable income and non-taxable income. Since only the portion "allocated" to the non-taxable income is disallowed as a deduction, petitioner concludes that there is no imposition of tax on state and municipal bond interest. Petitioner's argument ignores the fact that the expense being allocated—the annual increase in reserves necessary to provide for policyholders' claims—is an expense of doing business as a life insurance company which would be incurred whether or not tax-exempt interest has been received. The annual deduction for this expense is nothing more than the application of accrual accounting to the life insurance business. It affords no "unique tax advantage" (P. Br. 15).[3]

This expense is not incurred in earning tax-exempt income, and it does not vary with the amount of such income. To "allocate" such an expense to tax-exempt income would be a novel and radical departure from the policy followed by Congress in the tax laws and by this Court in *National Life*. The denial of deductions under these circumstances amounts to the inclusion of tax-exempt interest in gross income. Far more is at

[3] A life insurance company can no more be described as an "80% tax-exempt taxpayer" (P. Br. 64-65 n.25) than an industrial company which incurs expenses in carrying on its business equal to approximately 80% of its gross income. Both are "fully taxable" on their net income.

stake than the "reasonableness" of an apportionment (P. Br. 29). The basic exemption of state and municipal bond interest from Federal income taxes is placed in question by petitioner's position here.

Petitioner's "allocation" argument deprives the adjustment clauses of any economic substance. Petitioner's sole explanation for the clauses is the self-contradictory assertion that Congress wished to prevent constitutional litigation over whether state and municipal bond interest is exempt from Federal taxation, but only if it should be determined that a tax is imposed on such interest. Respondent agrees that Congress intended to avoid constitutional litigation involving the sensitive area of intergovernmental immunities. This can be done, however, only if the standard of exemption to be applied is the traditional standard affirmed in *National Life*.

If the rationale of *National Life* is to be disregarded, this Court must consider whether the "allocation" of unrelated expenses to tax-exempt interest is constitutionally permissible. This cannot be done without a thorough examination of the nature and scope of the constitutional exemption of state and municipal bond interest. If an economic burden on the receipt of such interest can be imposed to this extent—in this case a 29.1% burden—where is the line to be drawn? There is no occasion for the Court to reach such important questions. Congress was aware of this Court's views as announced in *National Life*. It did not question these views. On the contrary, it took affirmative action by enacting Sections 804(a)(6) and 809(b)(4) to ensure that the traditional immunity of state and municipal bond interest as understood by it in the light of that

decision would not be disturbed and to make it clear that it did not wish to provoke constitutional litigation under the Life Insurance Company Income Tax Act of 1959 which would bring into issue the extent of this immunity. The traditional immunity can be preserved only if the adjustment clauses are applied to eliminate the increase in respondent's tax that occurs solely because of the receipt of state and municipal bond interest, as ordered by the Court of Appeals.

ARGUMENT

I

Sections 804(a)(6) and 809(b)(4) Apply Where an Increase in Tax Would Result From the Inclusion of State and Municipal Bond Interest in the Tax Computation of a Life Insurance Company.

Sections 804(a)(6) and 809(b)(4) were added to the Life Insurance Company Income Tax Act of 1959 in order to ensure above all else that the statutory formulae for taxing life insurance companies would not result in an economic burden being placed upon state and municipal bond interest and that no departure would be made from the traditional policies of protecting such bonds from impairment by Federal taxation. The setting in which these provisions were enacted can best be understood by a brief review of the prior history to which Congress' attention was directed.

A. Tax Legislation and Judicial Decisions Prior to the 1959 Act.

A method for determining the reserve liability deduction for life insurance companies which was uni-

form for all companies was first provided in the Revenue Act of 1921.[4] The deduction was equal to the amount by which 4 percent of the mean of each company's reserve funds required by law (the computation of which was not affected by tax-exempt interest) exceeded the company's tax-exempt interest. Revenue Act of 1921, ch. 136, § 245(a)(2), 42 Stat. 261.

In *National Life Ins. Co.* v. *United States*, 277 U. S. 508 (1928), the Court recognized that by diminishing the 4 percent deduction which would have been fully deductible from National Life's taxable income if it had not received any tax-exempt income, National Life was required to pay an increased tax because of the receipt of state and municipal bond interest. The Court held that this resulted in the taxation of the exempt income contrary to both the statutory exemption afforded under Section 213(b)(4) of the Revenue Act of 1921, ch. 136, 42 Stat. 238 (comparable to Section 103 of the Internal Revenue Code of 1954) and the Constitution of the United States, and that it could not be given effect. In its opinion, the Court said:

> "If permitted, this would destroy the guaranteed exemption. One may not be subjected to greater burdens upon his taxable property solely because

[4] Prior to 1921 the deduction was related to reserve additions required by law or found by the Commissioner to be required for the protection of policyholders. The uncertain meaning of these provisions was found in 1921 to be confusing and productive of continued litigation. Subcommittee on the Taxation of Life Insurance Companies of the House Ways and Means Committee, A Preliminary Statement of Facts and Issues With Respect to the Federal Taxation of Life Insurance Companies, 83rd Cong., 2d Sess. 18-19 (1954).

he owns some that is free. No device or form of words can deprive him of the exemption for which he has lawfully contracted. . . .

"The burden from which federal and state obligations are free is the one laid upon other property. To determine what this burden is requires consideration of the mode of assessment, including, of course, deductions from gross values. What remains after subtracting all allowances is the thing really taxed.

". . .

"Congress had no power purposely and directly to tax state obligations by refusing to their owners deductions allowed to others." 277 U. S. at 519, 520, 522.

In the Revenue Act of 1932, ch. 209, § 203(a)(2), 47 Stat. 224, the provision reducing the deduction for reserve liability increases by the full amount of tax-exempt interest was dropped from the statute.[5] At the same time the statutory rate used to determine the reserve deduction was reduced by Congress from 4 percent to 3¾ percent for the purpose of restoring the overall tax base to substantially the same status as it had been prior to the decision in *National Life*. See *Hearings Before the Senate Finance Committee on H. R. 10236*, 72d Cong., 1st Sess. 332 (1932). There was no suggestion at that time that the decision in *National Life* could be overcome simply by providing that the reserve deduction should be reduced by an allocable portion of tax-exempt interest instead of the

[5] After the decision in *National Life*, the regulations under the Revenue Acts of 1921, 1924 and 1926 were amended to provide that life insurance companies were entitled to deduct 4 percent of their reserve funds "without any abatement on account of tax-exempt interest." T. D. 4231, VII-2 Cum. Bull. 299, 300 (1928).

full amount of such interest. It was clear that this would not be permitted.

In *National Life* the Court had referred with approval to *Packard Motor Car Co.* v. *City of Detroit*, 232 Mich. 245, 205 N. W. 106 (1925), and in summarizing that case it had noted that deductions under the property tax there held invalid had been reduced by only a proportionate share of United States government obligations. And in *Missouri* ex rel. *Missouri Ins. Co.* v. *Gehner*, 281 U. S. 313 (1930), a similar method of reducing deductions under a state ad valorem property tax applicable to insurance companies had been held invalid by the Court on the authority of *National Life*. In its opinion in *Gehner*, the Court said:

> "It would be competent for the State to permit a less reduction or none at all. But where as in this case the ownership of United States bonds is made the basis of denying the full exemption which is accorded to those who own no such bonds this amounts to an infringement of the guaranteed freedom from taxation. It is clear that the value of appellant's government bonds was not disregarded in making up the estimate of taxable net values. That is in violation of the established rule. *Nat'l. Life Ins. Co.* v. *United States, supra. Northwestern Ins. Co.* v. *Wisconsin*, 275 U.S. 136. *Miller* v. *Milwaukee*, 272 U.S. 713." 281 U.S. at 321-22.

Furthermore, *National Life* had been reaffirmed in *Denman* v. *Slayton*, 282 U. S. 514 (1931), decided the next term after *Gehner* with the opinion for the Court being written by the same Justice who wrote the Court's opinion in *National Life*. The statute in *Slayton* disallowing deductions for interest on indebtedness

"incurred or continued to purchase or carry" tax-exempt securities was indeed a logical extension of *National Life*, for if tax-exempt income is excluded from the tax computation, expenses directly connected with the earning of such income should also be excluded. The Court recognized, however, that this was entirely different from denying deductions for expenses which would have been incurred regardless of the receipt of tax-exempt income. Stating that these were the circumstances present in *National Life*, the Court reiterated the holding in that case without purporting to limit the holding in any respect.[6]

In 1942 the Treasury Department initially proposed that the reserve liability deduction should continue to be determined by applying a statutory rate (to be reduced from 3¾% to 3¼%) to the individual company's reserves, but that the deduction should be reduced "by the percentage that tax-exempt interest bears to total investment income". *Hearings Before the House Ways and Means Committee on Revenue Revision of 1942*, 77th Cong., 2d Sess. 86 (1942). This proposal was objected to as violating *National Life*. *Id.* at 3211. At the same time the Treasury Department proposed to Congress that the statutory provisions exempting state and municipal bond interest from Federal income taxation should be repealed. *Id.* at 8; *Hearings Before the Senate Finance Committee on H. R. 7378*, 77th Cong., 2d Sess. 3-4 (1942). The whole question of Congressional policy with respect to the

[6] *Helvering* v. *Independent Life Ins. Co.*, 292 U. S. 371 (1934), which applied the same principle as *Slayton* and distinguished *National Life* for the same reason given in the *Slayton* opinion, is discussed *infra* at pp. 47-48.

exemption of such interest was debated at length in hearings before both the House Ways and Means Committee and the Senate Finance Committee. Both committees turned down this proposal.

The reserve liability deduction for life insurance companies that was finally adopted in the Revenue Act of 1942, ch. 619, § 163, 56 Stat. 870, was expressed as a percentage of net investment income. The percentage was computed by the Secretary of the Treasury for the entire life insurance industry, and each company applied the percentage to its own investment income to determine the amount to be deducted. While tax-exempt interest was taken into account in the formula for determining the percentage to be applied on an industry-wide basis, the individual company's tax liability was not affected by the fact that it received more or less tax-exempt interest than the industry-wide average used in the computation.

The deduction continued to be determined by similar methods under various formulae through 1957.[7] Thus, from 1942 through 1957, no question could arise as to whether a tax was imposed on the tax-exempt interest received by an individual company, since any individual company could obtain the full tax benefit of the exemption on any state and local bonds held by it.

B. Legislative History of the 1959 Act.

For many years prior to 1958, extensive studies were made by the Treasury Department, Congress and the

[7] These formulae are described in Report on the Taxation of Life Insurance Companies By the Subcommittee on Internal Revenue Taxation of the House Ways and Means Committee, 85th Cong., 2d Sess. 2, 4-5 (1958).

life insurance industry of proposals for establishing an individual company basis for determining the deduction for reserve liability increases.[8] It was also proposed that life insurance companies, which had since 1921 calculated their tax liabilities on the basis of investment income alone, should be taxed on the basis of their total income, including net gains from insurance operations resulting from favorable experience with mortality and expense assumptions. A subcommittee of the House Ways and Means Committee appointed to study the problem concluded that an individual company basis for determining the deduction was desirable, but only if the deduction was based on a method which was not affected by variations between companies in the assumptions used in calculating reserve liabilities for state reporting purposes.[9]

The plan ultimately approved by the sub-committee at the suggestion of the Treasury Department and passed by the House of Representatives established the basic approaches to the tax computation reflected in the Act that was finally adopted. The taxable income of the company was primarily its net investment income, but if it had a net gain from its overall operations in excess of taxable investment income, 50 percent

---

[8] *E.g.*, Subcommittee on Taxation of Life Insurance Companies of the House Ways and Means Committee, A Preliminary Statement of the Facts and Issues With Respect to the Federal Taxation of Life Insurance Companies, 83d Cong., 2d Sess. (1954). The *National Life* decision was usually referred to in these studies. See *id.* at 19.

[9] Report on the Taxation of Life Insurance Companies By the Subcommittee on Internal Revenue Taxation of the House Ways and Means Committee, 85th Cong., 2d Sess. 5 (1958).

of the excess was also included in taxable income.[10] Reserve liability increases based on assumed interest rates were used only in computing gains from operations; in the more important calculation of "taxable investment income", the deduction was determined by a formula based in part on the company's actual earning rates.[11] Both phases of the House bill contained provisions, which came to be known as the "add-back" clauses, pursuant to which the deductions for reserve liability increases were reduced by the proportion of the state and municipal bond interest received by the company that was equal to the ratio that the reserve liability requirements bore to total investment income. H. R. 4245, 86th Cong., 1st Sess., §§ 805(e), 809(f)(1), reproduced in *Hearings Before the Senate Finance Committee on H. R. 4245*, 86th Cong., 1st Sess. 7, 9-10 (1959) [hereinafter called *"Senate Hearings"*]. The bill did not contain any adjustment provisions comparable to Sections 804(a)(6) and 809(b)(4).

In the Senate Finance Committee, representatives of state and local governments complained that the increase in the tax liability of life insurance companies

[10] In both the House bill and the final Act, if "gain from operations" is less than "taxable investment income", then "life insurance company taxable income" includes only "gain from operations". In most cases, however, "gain from operations" is limited to "taxable investment income" less $250,000 under Section 809(f). Petitioner overlooks this important limitation when it states that "gain from operations" has the "greater impact" on the company's final taxable income. P. Br. 3-4 n.l. The Senate Finance Committee estimated that $460 million of the $500 million expected to be derived for 1958 under the bill which became the final Act would be attributable to "taxable investment income". S. Rep. No. 291, 86th Cong., 1st Sess. 12 (1959).

[11] In the Act finally adopted, actual earnings rates are used exclusively in determining "taxable investment income".

which would result from the receipt of state and municipal bond interest would increase the cost of borrowing by state and municipal governments since a higher interest rate would be required to make their obligations competitive with fully taxable obligations. Referring to this aspect of the House bill, Senator Talmadge stated to the Committee:

> "One of my constituents goes so far as to make this assertion: Under present market conditions, taxable utility bonds are currently offered to yield about 4.6. Under the proposed new tax bill in order to be comparatively attractive municipal bonds would have to yield approximately 4.10. This excludes the great bulk of municipal bonds currently being offered in the range of three, three and three-quarters. If full tax-free status is granted his company would be interested in this type of security, on yields as low as approximately 3½ percent.
>
> "If his contention is correct, that will vastly affect the market authority of the county bonds and others.
>
> ". . .
>
> "It would be a very important thing not only to insurance companies but to counties, States, and municipalities that build hospitals, school buildings, and things of that type, if they suddenly found their interest rate raised to the degree of maybe three-quarters of 1 percent, This being true when trying to be competitive in the market when selling their obligations. This is important not only to the insurance companies and the taxpayer, but it is of vast importance also to those subdivisions of State governments in States at the

present time which have tax-exempt status." *Senate Hearings* pp. 45-46, 47-48.[12]

As petitioner acknowledges (P. Br. 64), it was made overwhelmingly clear to the members of the Senate Finance Committee that the increase in tax necessarily resulting from the "add-back" provisions of the House bill would make state and municipal bonds a less attractive investment for life insurance companies. It was also recognized, as Senator Talmadge indicated in the statement just quoted, that because of the lower yield on such bonds no special advantage was derived by life insurance companies from the exemption of such interest from Federal income taxes.

There is nothing in the record of the hearings to support petitioner's assertion (P. Br. 75) that the majority

---

[12] Senator Butler said in a statement inserted in the record of the hearings:

> "Permanent provisions of [a] statute taxing the interest on State and local bonds held by life insurance companies would have a serious depressant effect upon the State and municipal bond market at a time when many communities of our Nation are finding it difficult, if not impossible, to sell such securities to meet the cost of much-needed capital improvements." *Senate Hearings* 700.

Senator Butler's statement also referred to "the many statements the Finance Committee has received from municipal groups warning of the grave danger this proposal holds in store for them." *Senate Hearings* 701. See, for example, the following telegram from the Mayor of Jacksonville, Florida to Senator Byrd, the Chairman of the Senate Finance Committee:

> "Urgently request Senate avoid impairing municipal bond market and increasing cost of municipal financing through indirect repeal of section 103 in proposed life insurance company tax bill, H. R. 4245. Such action would have very serious consequences for Jacksonville's progressing urban redevelopment program, a program being financed entirely through our own credit and revenues and without 1 penny of Federal aid." *Senate Hearings* 593.

See also *Senate Hearings* 699-700.

of the members of the Committee agreed with the Treasury Department's view that the "add-back" provisions of the House bill were necessary in order to be "fair". No member of the Committee questioned the soundness of the policy of complete exemption long followed by Congress, although it was brought out early in the hearings that the "apportionment of deductions" would necessarily contravene that policy. On the contrary, there were only expressions of support for the exemption. Furthermore, the unfairness of applying the approach of the House bill to life insurance companies but not to other taxpayers was criticized by Committee members, *e.g., Senate Hearings* 45, 48, 58, 411, and no satisfactory answer was given by the Treasury Department.

In addition to concern over the economic effect of the House bill, the constitutional validity of the add-back provisions was questioned at the very outset of the hearings when Senator Butler asked the Assistant to the Secretary of the Treasury, Mr. David A. Lindsay, whether these provisions would be invalid under the Constitution as interpreted by two decisions of the Supreme Court, obviously referring to *National Life* and *Gehner*. Mr. Lindsay's reply was: "I think this question might very well be litigated." *Senate Hearings* 43-44. Senator Butler then made the following statement:

> "[The bill] should not be tailored so as to embody doubtful legal provisions. . . .
>
> "I feel, as I have said, that the Supreme Court has been critical of this Congress for legislating in areas such as this. In addition we cannot rely upon

> the Supreme Court of the United States reversing two previous decisions on this point, and I feel that the Treasury should give this serious consideration." *Senate Hearings* 44.

Senator Talmadge also expressed concern with the constitutional question and asked Mr. Lindsay to look into the matter in more detail. *Senate Hearings* 48. The Treasury Department then submitted a memorandum which in a brief discussion of *National Life* stated that the statute involved in that case was "different" from the House bill and suggested that the trend of more recent decisions "casts considerable doubt on the constitutional aspects of the *National Life* case". *Senate Hearings* 50-51. No other decisions were cited, and the *Gehner* case was not even mentioned.

Subsequently Senator Butler inserted in the record of the hearings two memoranda in which both the *National Life* and *Gehner* cases were discussed at length, and the conclusion was expressed that the add-back provisions of the House bill could not be sustained under those decisions.[13] *Senate Hearings* 516-18, 700-2. One of these memoranda also stated:

> "Despite more recent decisions on collateral questions, these decisions remain unmodified and unchallenged. As such, they are the only appropriate guideposts in considering this vital question of constitutionality." *Senate Hearings* 701.

---

[13] After quoting from the opinion in *National Life*, Senator Butler stated:

> "Note specifically that as in the National Life Insurance Company case the Treasury Department advocates that a so-called deduction allowed to a general class of taxpayers be diminished solely because of the receipt of interest from tax exempt securities." *Senate Hearings* 518.

Numerous other memoranda submitted by witnesses and interested parties repeatedly asserted that the method of taxation adopted in the House bill could not be reconciled with the constitutional immunity required by *National Life*, and that the method of allocation held invalid in *Gehner* on the authority of *National Life* was indistinguishable. *E.g., Senate Hearings* 305, 309, 311-12, 318, 407-8, 614, 632. Senators Byrd and Kerr expressed particular interest in the statement submitted by Mr. Harold J. Cummings, the President of Minnesota Mutual Life Insurance Company, one of the most comprehensive statements on this subject which, after a thorough analysis of the issues, concluded that the House bill "plainly proposes to contravene" *National Life* and that *National Life* "has never been repealed or qualified. It is the law of the land." *Senate Hearings* 308, 414 referring to the statement at 308-322. (This occurred after the exchange between Senator Kerr and Mr. Henry S. Beers to which petitioner refers at P. Br. 73-74.) There is nothing to support petitioner's claim (P. Br. 65) that most members of the Committee "apparently agreed" with the Treasury Department's viewpoint. Indeed, the record of the hearings discloses only expressions of concern by Committee members, a concern which was not that of Senator Butler alone. *E.g., Senate Hearings* 48 (Senator Talmadge), 58 (Senator Hartke), 59 (Senator McCarthy), 308 (Senator Byrd), 411 (Senator Talmadge), 414 (Senator Kerr), 420 (Senator Carlson).

The Senate Finance Committee redrafted the House bill, changing the reserve deduction to an exclusion for the "policyholders' share" and against the foregoing background it added the adjustment clauses. The report of the Senate Finance Committee recommended the division of investment income between the "policyholders' share" and the "company's share" as a "better concept" and it stated that a deduction was allowed for the tax-exempt interest included in the "company's share". The report went on to say that the committee had "added" the adjustment clauses, no doubt after the other changes had been made, and referring to these clauses the report stated that "in no case is any tax to be imposed on tax-exempt interest, on the thirty fifty-seconds of partially tax-exempt interest, or on the 85 percent of the dividends received." S. Rep. No. 291, 86th Cong., 1st Sess. 6, 17, 18 (1959). Thus the adjustment clauses assured not only that there would be no imposition of tax on state and municipal bond interest, but also that there would be no dilution of the exemption from normal tax provided for certain United States government obligations or of the inter-corporate dividends received deduction by reason of the revised method of taxing life insurance companies proposed by the committee.

Anyone familiar with the controversy that had developed at the hearings only two months earlier, regardless of whether he believed he fully comprehended the operation of the complex formulae contained in the bill as redrafted, could only have concluded from

this and other similar statements in the report,[14] excerpts from which were printed in the record of the Senate debates (105 Cong. Rec. 8402-8406), that the traditional immunity of state and municipal bonds would not be changed in any event, even if adjustments had to be made to accomplish this. When it was realized that there were doubts as to whether the basic exemption of state and municipal bonds was being provided, affirmative steps were taken to make sure there would be no deviation from the policy of complete exemption followed in all tax laws since the decision in *National Life*.

The same theme was repeated throughout the subsequent debates in both Houses of Congress, and, with the sole exception of Senator Curtis' statement quoted in petitioner's brief (p. 68), the adjustment clauses were mentioned each time it was said that state and municipal bond interest would not be taxed. Senator Curtis, a non-senior member of the Republican minority who could hardly have been regarded as the "spokesman" for the Committee (P. Br. 65, 67), indicated that he thought the deduction for the tax-exempt interest included in the "company's share" was adequate to

---

[14] *E.g.*,

"The purpose of your committee in providing this treatment is to exempt a life insurance company from tax on any tax-exempt interest . . . . To give further assurance that no tax is to be imposed on tax-exempt interest . . . , your committee has added a special paragraph to the bill providing that if the application of the definition of taxable investment income does result in the imposition of tax on tax-exempt interest, . . . adjustment is to be made to the extent necessary to prevent any such imposition." S. Rep. No. 291, *supra*, at 17.

See also *id.* at 2, 19, 24.

assure the exemption. However, in his explanation of the operation of the bill he did not indicate that when tax-exempt interest was "allocated" to the "policyholders' share", a larger portion of the taxable items of investment income would be taxed to the company, and that the tax liability would thus increase or decrease as the amount of tax-exempt interest received increased or decreased. See 105 Cong. Rec. 8429.[15] It is evident that the other members of the Senate Finance Committee who voted to add the adjustment clauses had doubts about the operation of the bill despite this explanation.

Senator Byrd, who was the spokesman for the Senate Finance Committee and its chairman, in explaining the bill to the Senate stated without qualification that "it was the intention of the committee not to impose any tax on tax-exempt interest". After stating that the Treasury had assured the committee that the

[15] Senator Curtis gave the following example:

"Let us suppose that in a given year a company has $100 of tax-exempt interest income, and that it is determined that 70 percent of its investment income is needed to build up its life insurance reserves and annuity reserves to meet future claims of policyholders and beneficiaries. Under the bill, $70 of the $100 tax-exempt interest income would be allocated to policyholders reserves and the other $30 would be allocated to the company. Since no part of the policyholders reserves would become a part of the tax base, no part of the $70 tax-exempt interest allocated to those reserves would be taxed. Moreover, no part of the $30 allocated to the company would be taxed, because a deduction of the full $30 would be made in determining what part of the company's share of its investment income was to be subjected to tax.

"Thus, no tax-exempt income or credits of life insurance companies will be included in the tax base of such companies, under this bill. This should allay any fear that any constitutional provision is transgressed." 105 Cong. Rec. 8429.

bill did not impose any tax on tax-exempt interest,[16] he went on to say:

> "The bill adds a proviso to the effect that if the formula I have described does result in the imposition of a tax on this item, the formula is to be adjusted so that it does not do so." 105 Cong. Rec. 8401.

Thus the Senate was informed that although there were doubts as to whether full exemption was accorded to state and municipal bond interest under the formula, the adjustment clauses added by the Senate Finance Committee insured that the exemption would be preserved above all, even if changes had to be made in the formula to accomplish this. There is no basis for the assumption implicit in petitioner's argument (*cf.* P. Br. 76) that Congress would have passed the bill with the adjustment clauses omitted. The bill on which it voted contained the adjustment clauses and there is every basis for assuming that it would not have been passed without them.

---

[16] The letter from the Treasury Department inserted in the record of the Senate debates, which did not indicate that the amount of the tax would be affected by the receipt of state and municipal interest, expressed the "opinion" "that the bill does not result in the imposition of any tax on the tax-exempt interest on State and municipal bonds." 105 Cong. Rec. 8402. If this was an opinion on the constitutional question, it was not responsive to the concern expressed in the Congressional debates as to whether the basic exemption would be provided for state and municipal bond interest. If it was an opinion that the policy of exemption traditionally followed by Congress would not be violated, it was simply wrong.

The telegram from the larger insurance companies approving the proration method of treating tax-exempt interest (105 Cong. Rec. 8402, quoted at P. Br. 74) is not indicative of Congress' purpose in enacting the adjustment clauses, which were not mentioned in the telegram, since these companies were more concerned with other issues than with the treatment of tax-exempt interest.

The changes in the bill made by the Senate were agreed to by the House in conference,[17] and the adjustment clauses remained in the bill although the Treasury Department may have attempted to have them removed at that point. In the final debates in both the House and the Senate on the bill with the adjustment clauses retained, the question of the taxation of state and municipal bond interest was again considered in a context which simply cannot be reconciled with petitioner's interpretation of the clauses. In the debate in the House, Congressman Mills, in answer to an inquiry expressing positive concern over the treatment of tax-exempt interest and inter-corporate dividends, said:

> "The pending bill clarified the language of the House bill to make it definite that we do not intend to tax the interest on tax-exempt securities. It provides that if it is established in any case that any provision of the bill results in levying a tax on tax-exempt securities such provision shall be adjusted so that it does not do so. This is a different approach from previous revenue acts passed since 1942 as the old laws were based upon the experience of the industry as a whole rather than on the experience of each individual company." 105 Cong. Rec. 10414.

In addition, Congressman Simpson said:

> "The treatment of tax-exempt interest under the conference version of the bill will make it more clear that such exempt income is not to be subject to tax." 105 Cong. Rec. 10413.

---

[17] H. R. Rep. No. 520, 86th Cong., 1st Sess. 14-15, 16 (1959).

Senator Byrd, who explained the conference agreement to the Senate, stated:

> "I am glad to report to the Senate that the House conferees accepted the Senate amendment relating to tax-exempt interest. This amendment provided that if it is established in any case that the application of the definition of taxable investment income results in the imposition of the tax on any tax-exempt interest, . . . adjustment shall be made to prevent such imposition." 105 Cong. Rec. 10400.

Finally, in a revealing colloquy, Senator Thurmond inquired of Senator Byrd:

> "As I understand from the report, county and municipal bonds will not be taxed under the bill. Is that correct?"

Senator Byrd again referred to the adjustment clauses in his response:

> "That is my construction. There is a proviso that if by any chance under the bill they should be taxed, necessary steps will be taken to refund the tax."

Senator Thurmond thereupon remarked:

> "I was vitally interested in it. I believe it means a great deal to the people of our Nation to preserve our State municipal bonds untaxed by the Federal Government."

Senator Byrd agreed. 105 Cong. Rec. 10400.

No one could have understood these statements as meaning that state and municipal bond interest would

be accorded any different treatment under the bill than the complete exemption that Congress has long provided for all taxpayers, including life insurance companies. Surely the exemption which the Senate was told was being "preserved" would not permit the tax to be increased solely because of the receipt of state and municipal bond interest—a result which, apart from the provision held invalid in *National Life*, Congress has never provided for any taxpayer.[18] It is no "slander on the legislative process" (P. Br. 58) to give these statements the ordinary meaning which anyone hearing or reading them would understand. Every time state and municipal bond interest was mentioned, it was emphatically stated that no tax would be imposed on it, and the adjustment clauses were almost always referred to as assuring this. These repeated statements could not have been made if the adjustment clauses were intended, as petitioner attempts to interpret them, to operate like savings clauses which would apply only in the event that the tax imposed without adjustments was invalid under the Constitution. There was no suggestion that the tax would be imposed in a manner that could raise any question as to whether state and municipal bond interest was exempt.

While the Treasury and some members of the Congressional tax committees may have understood the

---

[18] The fundamental difference to which Congressman Mills made specific reference, *supra* p. 27, between the 1959 Act and the 1942 Act, which did not have any effect on the individual company's receipt of tax-exempt interest, shows the fallacy of petitioner's assertion (P. Br. 12) that the two Acts were identical "in principle" with respect to the treatment of tax-exempt interest.

effect of the revised statutory formulae that were substituted in the Senate, the fact that these formulae would require a taxpayer with tax-exempt interest income to pay a higher tax than it would have had to pay had it not received such income was by no means "self-evident" or "plain and understood" by everyone (P. Br. 71, 73). The bill was a highly complicated one. Whatever may have been the understanding by the Treasury and some committee members, the fact is that there was no straightforward disclosure of this crucial point on the floor of either House when the many members of Congress who did not participate in the committee hearings were called upon to vote. It was not pointed out that the conceptual change in the allocation formula from a deduction to an exclusion was a change without economic difference, except possibly for an implication in the general statement made by Congressman Mills in the House quoted at P. Br. 70. At no point, even in response to specific questions, was it ever stated on the floor of either House that the effect of the bill without the adjustment clauses would be to increase a life insurance company's tax liability solely because of its receipt of state and municipal bond interest. Surely if this result was as "self-evident", "plain" and "understood" as petitioner says it was, the distinguished Congressmen who presented the matter on the floor of each House would have been impelled to point it out if they had not thought that the adjustment clauses negatived such a result, thereby making any reference to it unnecessary. Any other conclusion, we submit, is "utterly implausible".

II

Petitioner's Apportionment Argument Disregards the Traditional Immunity of State and Local Government Obligations From Federal Income Taxation and Raises Constitutional Questions That This Court Should Avoid.

Petitioner's entire argument is based on the premise that no tax is imposed on state and municipal bond interest if the statutory scheme provides a "fair" apportionment of deductions between classes of income. In petitioner's view the question to be considered "is not whether the tax is more, but whether the . . . apportionment is reasonable". (P. Br. 29) If a deduction is disallowed on account of a reasonable apportionment, the inquiry ends because the taxpayer has been treated "fairly". Throughout its brief, petitioner neglects the fact that the constitutional immunity with which Congress was concerned is one designed to protect state and local governments. Nowhere does petitioner make any attempt to establish that the method of apportionment applied by it will not have an adverse economic effect on state and local governments. Nowhere does petitioner consider the effect on the state and local governments because "the tax is more".

Petitioner's attempt to justify an "allocation" of the reserve deduction to tax-exempt interest on the ground that such allocation is "fair" misconceives the nature of the exemption of state and municipal bond interest from Federal taxation. It is not enough that an "allocation" be "fair" in the sense that it does not discriminate against the receipt of tax-exempt interest.

If this were the test of immunity, state and municipal bond interest could always be taxed. Under our Federal statutes and Constitution, the obligations of state and local governments are given a preferred position in order not to impair the borrowing power of the States. See *Helvering* v. *Gerhardt*, 304 U. S. 405, 417 (1938); *Hale* v. *Iowa State Board*, 302 U. S. 95, 107 (1937); *Pollock* v. *Farmer's Loan & Trust Co.*, 158 U. S. 601, 630 (1895). Because of this preferred position, no tax, not even a non-discriminatory one, may be imposed on state and municipal bond interest by the Federal government.

Because of the exemption of state and municipal bond interest from Federal income taxation, the market places a premium on state and municipal bonds and permits such obligations to be sold at a lower yield than corporate obligations of similar grade. By investing in state and municipal bonds, life insurance companies and other investors forego the higher yield that could be obtained from taxable securities. Thus, the real beneficiary of the exemption of state and municipal bond interest from Federal income taxation is not the life insurance company that invests in such bonds but the state and local governments that issue the obligations purchased by the company. In resisting the various attempts of the Treasury Department to limit the state and municipal bond exemption, Congress has recognized this. If deductions may be allocated in the manner suggested by petitioner, it can only operate to the detriment of the state and local governments. Life insurance companies could not afford the reduction in yield without the full benefit of the immunity.

Under petitioner's argument, the sole explanation for the adjustment clauses is the prevention of litigation on the question of whether state and municipal bond interest may be taxed by the Federal government under the Constitution but, inconsistently, petitioner argues that the clauses apply only in the event that it is first found that the statutory formulae violate what petitioner characterizes (*e.g.*, P. Br. 35) as the "assumed" constitutional prohibition against imposing a tax on interest from state and municipal bonds. Of course, since it is petitioner's contention that the statutory formulae do not do this, the adjustment clauses are a mere appendix to the statute, which need be given no substantive meaning.

Petitioner's contention that the function of Sections 804(a)(6) and 809(b)(4) is to provide an adjustment only if the statutory formula "violates the assumed constitutional prohibition against a tax on interest from state bonds" (P. Br. 62) would of course raise the very constitutional questions which Congress intended to avoid. The determination whether the operation of the formula "violates the assumed constitutional prohibition" is itself constitutional litigation which if relevant would require a thorough examination by the Court of the scope and purpose of the immunity from taxation of state and local bonds. The life insurance company taxing formula obviously cannot be tested against an "assumed" constitutional standard without full discussion of the standard to be applied and without full knowledge of the economic and other effects of applying the standard.

As a matter of sound judicial policy, this Court does not consider constitutional questions where such ques-

tions may be avoided. And where a case may be decided on either of two grounds, one involving a constitutional question, the other a question of statutory construction, this Court will decide only the latter. *Ashwander* v. *Tennessee Valley Authority*, 297 U. S. 288, 347 (1936); *Rosenberg* v. *Fleuti*, 374 U. S. 449, 451 (1963). As Chief Justice Hughes said in *Crowell* v. *Benson*, 285 U. S. 22, 62 (1932), "... it is a cardinal principle that this Court will first ascertain whether a construction of the statute is fairly possible by which the [constitutional] question may be avoided.". The importance of applying this policy is particularly present where the constitutional area involved is the sensitive area of inter-governmental tax immunities involving the relationship of state and local governments to the Federal government. Certainly, this Court should reject an interpretation of the statute which would narrow the traditional immunity and raise a constitutional question, particularly where the question has not been fully canvassed by the lower courts, and the record does not show the economic and other effects of such action on state and local governments. Petitioner has presented no evidence which would justify this Court's narrowing the immunity and reaching the constitutional question Congress intended to avoid. The traditional immunity can only be preserved if *National Life* is followed and Sections 804(a)(6) and 809(b)(4) are given substantive meaning.

A. The *National Life* Decision Must Be Followed.

No one, we submit, can read the decisions of this Court in the *National Life*, *Gehner* and *Slayton* cases without concluding that the Court intended in those

cases to establish that the constitutional immunity of interest on state and municipal bonds from taxation would be violated by the imposition of a greater tax on one's taxable income, through disallowance of deductions not directly attributable to the earning of tax-exempt income, solely because he received tax-exempt income. While petitioner says that the function of the adjustment clauses is to provide for adjustments only if the statutory formulae cannot be applied consistently with "the established constitutional immunity" from taxation of interest on state and municipal bonds (P. Br. 53), yet in effect it argues that the doctrine established by these cases should be disestablished and a new one substituted. Thus, according to petitioner, in legislating with a view toward the established doctrine in this area Congress meant not the existing doctrine established by these unreversed decisions but a "living growing body of principles" (P. Br. 59) that might hopefully be developed in this or some future litigation. This interpretation cannot be sustained.

In *Helvering* v. *Griffiths*, 318 U. S. 371 (1943), where the statute expressly referred to the Constitution as the standard, the Commissioner of Internal Revenue argued that the decision in *Eisner* v. *Macomber*, 252 U. S. 189 (1920), should not be followed because of subsequent cases just as petitioner in its brief (pp. 59-60, 61-62) seems to suggest that "existing law" might be different than *National Life*.

Griffiths is much closer to the present case than petitioner recognizes in its brief, as an examination of the legislative history considered by the Court in *Griffiths*

discloses. The question of the constitutional validity of *Macomber* was squarely faced by Congress when the Revenue Bill of 1936 was before it in connection with a proposal to tax the shareholders of corporations on the undistributed earnings of the corporation. 318 U. S. at 376-77 & nn.8-12. It was the discussion of this proposal, which was abandoned because of doubts that it would be constitutional, that the Court referred to as indicating that Congress had no intention "to challenge or override" the *Macomber* decision. 318 U. S. at 378. Similarly, during the same session of Congress that enacted the Life Insurance Company Income Tax Act of 1959, the question of Congress' power to tax income from state and municipal bonds in view of *National Life* and other decisions was the subject of extensive studies and discussions in Congress. See Compendium of Papers on Broadening the Tax Base Submitted to the House Ways and Means Committee, 86th Cong., 1st Sess. 679-791 (1959); Panel Discussions on Revision of the Federal Income Tax Structure Before the House Ways and Means Committee, 86th Cong., 1st Sess. 339-402 (1959). Congress took no action in 1959 to repeal the statutory exemption of such interest, consistent with its reaction to numerous similar proposals in prior years.[19]

In *Griffiths* the Court held that the question of the constitutional validity of *Macomber* could not be reached since Congress had not intended to legislate

---

[19] The history of these proposals is summarized in Compendium of Papers on Broadening the Tax Base Submitted to the House Ways and Means Committee, 86th Cong., 1st Sess. at 680-81, 702-4 (1959).

contrary to *Macomber*. In an opinion by Mr. Justice Jackson, the Court recognized that this question was "plainly one of the first magnitude", but then it said:

> "Under our judicial tradition, we do not decide whether a tax may constitutionally be laid until we find that Congress has laid it. Unless the tax asserted by the Commissio' has been authorized by Congress, it fails of va..dity before we even reach the constitutional question." 318 U. S. at 394.

After examining the legislative history in detail, Justice Jackson found no indication that Congress intended to act contrary to the *Macomber* decision, saying:

> "We think if Congress had passed or intended to pass an Act challenging a well known constitutional decision of this Court there would appear at least one clear statement of that purpose either from its proponents or its adversaries. Not one contemporaneous word in or out of Congress discloses the purpose which the Government says we should find that this legislation accomplished." 318 U. S. at 389.

The petitioner argued in *Griffiths*, somewhat as it does here, that the peculiar form of the statute was attributable to "embarrassment" which would have been incident to a "frontal attack" on *Eisner* v. *Macomber*. The Court refused, however, to speculate on the motives which may have led Congress to the choice employed in the language of the statute, stating that such speculation "has no place in the construction

of Acts of Congress".[20] 318 U. S. at 402. The Court also said:

> "We would be reluctant, in any event, to find that Congress intended to hold the effect of § 115(f)(1) in abeyance until the Treasury should decide that the time was ripe to challenge *Eisner* v. *Macomber* and carry its challenge to this Court. Such an intention would be a serious departure from the usual policy of Congress to provide the taxpayers and tax-gatherers with a practical basis for the timely settlement of questions of taxation arising each year." 318 U. S. at 399.[21]

Petitioner's interpretation of the adjustment clauses flies in the face of all the factors considered important in *Griffiths*. The Congress that enacted the Life Insurance Company Income Tax Act of 1959 clearly did not intend to challenge or override *National Life*. The repeated statements that no tax would be imposed on state and municipal bond interest made in the committee reports and the floor debates simply cannot be reconciled with any such intention, and the addition of provisions requiring adjustments in the taxing formula affirms that Congress intended above all to preserve that exemption of state and municipal bond interest. Those provisions obviously were not regarded

[20] In addition Justice Jackson noted that a literal reading of the statute, which used the word "does", led to the conclusion that Congress intended to determine taxability in terms of existing law, which at that time was found in the *Macomber* decision which had never been overruled. 318 U. S. at 394. In the present case, the statute uses the word "results" and existing law, as Congress was well aware, is to be found in *National Life*.

[21] A similar argument, characterized by the Court as "startling", was rejected in *Sinclair Ref. Co.* v. *Atkinson*, 370 U. S. 195, 209-10 (1962).

by Congress as only a "caveat"; they plainly constitute exceptions, and they affirmatively negate any "wanting" by Congress to increase the tax because of the taxpayer's receipt of state and municipal bond interest (P. Br. 61-62). The record of the legislative history does not contain a single statement indicating there would be any change in the nature of the exemption, least of all a change so fundamental as that which petitioner asks for here. And the reasons suggested by petitioner for the enactment of the adjustment clauses and its interpretation of the language of those clauses imputes to Congress the same motives which the Court in *Griffiths* refused to accept or even inquire into. As in *Griffiths,* there is no occasion for this Court to reexamine *National Life* since Congress plainly did not intend to impose a tax which would be invalid under the rationale of that decision.

Furthermore, petitioner's attempt to distinguish *National Life* because of differences in the amount of the reduction involved in that case cannot withstand analysis. The Court did not hold, as petitioner implies (P. Br. 37), that the deduction of all exempt interest from the reserve deduction, instead of only a "pro rata" portion, was the vice of the 1921 Act. In its discussion of *Packard Motor Car Co.* v. *City of Detroit,* 232 Mich. 245, 205 N. W. 106 (1925), the Court recognized that such an "allocation" of deductions on account of tax-exempt bonds had been employed, and it summarized approvingly the holding in *Packard* as follows:

> "... tax exempt credits may not be taxed, directly or indirectly, and in levying a tax on property

they must be treated as nonexistent." 277 U. S. at 521.[22]

The *National Life* opinion also referred with approval to *Northwestern Mut. Life Ins. Co.* v. *Wisconsin*, 275 U. S. 136 (1927), and *Miller* v. *Milwaukee*, 272 U. S. 713 (1927), both cases involving the incidence of a state tax on obligations of the Federal government,[23] to illustrate the principle of immunity. These cases, like *Packard*, make it clear that the Court in *National Life* was requiring that state and municipal

---

[22] In *Packard*, the Supreme Court of Michigan said:

"Tax exempt credits cannot be taxed, directly or indirectly. In laying a tax on property, tax exempt credits must be treated as nonexistent. The legislature may not make use of, or permit consideration to be taken of tax exempt credits as a factor in determining taxes to be paid by holders thereof. To do so would attach a condition to the enjoyment thereof wholly incompatible with the issuance thereof and impair the underlying contract." 232 Mich. at 247-48, 205 N. W. at 107.

[23] The *Northwestern* case considered a Wisconsin statute, which imposed a license fee on insurance companies at the rate of 3 per cent of gross income. Northwestern claimed that income from United States bonds could not be included in the computation of the tax. The state maintained that the tax was imposed on the privilege of doing business in the state, not on United States bonds. The Court held that the tax was nevertheless an imposition on the bonds, saying:

"[I]f the challenged Act, whatever called, really imposes a direct charge upon interest derived from United States bonds, it is *pro tanto* void." 275 U. S. at 140.

The *Miller* case considered a Wisconsin income tax statute which provided that all dividends were taxable income, but allowed a deduction for dividends received from corporations which themselves were subject to the Wisconsin income tax. The statute provided that where only part of the income of a corporation had been taxed, only a corresponding part of the dividend was deductible by the stockholders. The dividends in question came from corporations which owned United States bonds, the interest on which was exempt from tax at the corporate level; because of the exemption, the dividends were not fully deductible by the stockholders. The Court held that, although dividends to stockholders are not generally identi-

bond interest be treated as if it had not been received in calculating the tax on income which is taxable. Petitioner's statement that "there is nothing in *National Life* inconsistent with [petitioner's] position in the present case" (P. Br. 38) is legal nonsense.

The application of *National Life* to the "allocation" of deductions is made all the more clear by *Missouri* ex rel. *Missouri Ins. Co.* v. *Gehner*, 281 U. S. 313 (1930), which followed *National Life* in holding invalid an allocation formula which cannot be distinguished from the formula petitioner advocates here. Chief Justice Hughes separately concurred in *Gehner* "on the ground that this case is governed by *National Life Ins. Co.* v. *United States*, 277 U. S. 508." 281 U. S. 322. And the opinion in *Gehner* shows that none of the grounds on which petitioner attempts to distinguish *National Life* is of any substance.

Gehner cannot be distinguished on the ground that a state property tax was involved, for it uses the *National Life* case as a controlling precedent, and many of the cases cited in *National Life* involved the immunity of Federal obligations from state taxation. Both *National Life* and *Gehner* recognized the interchangeability of the principles applicable to the exemp-

---

fied with the corporate funds from which they are paid, it was necessary to do so in this case in order to protect the exemption of United States bonds. It said:

> "If the avowed purpose or self-evident operation of a statute is to follow the bonds of the United States and to make up for its inability to reach them directly by indirectly achieving the same result, the statute must fail even if but for its purpose or special operation it would be perfectly good." 272 U. S. at 715.

It held that tax was imposed on United States bond interest by reducing the stockholders' dividend deduction because of the United States bond interest received by the corporation, and that such tax was invalid.

tion of state and municipal bonds from taxation by the Federal government and the exemption of United States obligations from taxation by the states. And the *Gehner* opinion (quoted *supra* at p. 13) cited the *Northwestern* and *Miller* cases alongside *National Life*. These cases did not involve a property tax; the tax in *Northwestern* was a license fee measured by gross income, and the tax in *Miller* was a state income tax. Thus the exemption required in *National Life* and *Gehner* is identical: The ownership of exempt property or income may not be made the basis of diminishing a deduction which would be allowed if the taxpayer owned no such property or income.

Petitioner's claim that *Gehner* is different because Congress has enacted a statute exempting Federal obligations from state taxation overlooks the fact that Congress has consistently provided by statute the same exemption for state and municipal bond interest from Federal income taxes. The Congressional policy of complete exemption is applicable to both state taxation of Federal obligations and Federal taxation of state obligations.[24]

The Congress that enacted the Life Insurance Company Income Tax Act of 1959 took action to ensure

[24] The reason for the exemption of state and municipal bond interest in the corporate excise tax enacted as part of the Tariff Act of 1913, the first modern income tax law passed by Congress, was explained by Congressman Cordell Hull as follows:

> "The Supreme Court has often held that under our form of government the States have no power to tax the instrumentalities of the Federal Government and conversely that the Federal Government has no power under the Constitution to tax the instrumentalities of the States; not desiring to raise any constitutional question, or to arouse the antagonism of any of the States, this provision was inserted." 50 Cong. Rec. 508.

that income from Federal obligations would be excluded from gross income in computing state taxes on net income thus providing the same exemption as that provided state and municipal bond interest under the Federal income tax laws. Pub. L. No. 86-346, 73 Stat. 622; S. Rep. No. 909, 86th Cong., 1st Sess. 8 (1959).[25] Even before this amendment this Court had recognized that arguments similar to those made by petitioner here violated the exemption which Congress intended to provide. In *New Jersey Realty Title Ins. Co.* v. *Division of Tax Appeals*, 338 U. S. 665 (1950), it was held that even if the intangible property tax involved in that case were viewed as being imposed only on taxable property, the exemption was violated where the rate of assessment on the taxable property increased from 15 percent to 79 percent solely because the ownership of

---

[25] Section 3701 of the Revised Statutes of the United States, now 31 U. S. C. § 742 (Supp. IV, 1963), was amended to provide: "This exemption extends to exery form of taxation that would require that either the obligations or the interest thereon, or both, be considered, directly or indirectly, in the computation of the tax. . . ." The Senate Finance Committee explained this amendment as follows:

> "Present law provides that obligations of the United States are to be exempt from taxation by or under State or local authority. The Supreme Court has held that this includes the exemption of interest on U. S. obligations from taxation by or under State or local authority. It has been pointed out to your committee, however, that one State has taken the position that the statute as now worded does not prohibit a State from including interest on Federal obligations in computing 'gross income' upon which taxable net income is determined. The bill (sec. 105) makes it clear that the exemption for Federal obligations extends to every form of taxation that would require either the obligation, or the interest on it, or both to be considered directly or indirectly in the computation of the tax, except nondiscriminatory franchise taxes (or other nondiscriminatory non-property taxes imposed in lieu thereof) on corporations and except estate or inheritance taxes." S. Rep. No. 909, 86th Cong., 1st Sess. 8 (1959).

Federal bonds was taken into account.[26] The rationale of the cases involving apportionment of net income under state taxing statutes which are cited by petitioner (P. Br. 14, 28, 43-44) simply has no application where an exemption statute is involved. However, the rationale of the *New Jersey Realty Title* case is applicable in the present case since the Congressional policy with respect to the exemption of state and municipal bonds from Federal taxation is identical. In light of this Congressional policy, petitioner's suggestion that the Federal exemption is of a higher order than the state exemption has no merit and furnishes no basis for analytical distinction.

---

[26] In an opinion by Mr. Justice Clark, the Court said:

"If the assessment is considered to be 15 per cent of capital and surplus less liabilities or of entire net worth, we agree with the court below that the tax levied under § 54:4-22 does not impose a discriminatory burden on federal issues as did the tax statute against which § 3701 was invoked in *Missouri Ins. Co.* v. *Gehner*, 281 U. S. 313 (1930). But since the decision in *Bank of Commerce* v. *New York City, supra* [67 U. S. 620 (1863)], it has been understood that a tax on corporate capital measured by federal securities may be invalid even though imposed without discrimination against federal obligations.

"If, however, the assessment of $75,700 is viewed as if it were levied exclusively upon appellant's net worth remaining after deduction of government bonds and interest, the assessment would be discriminatory since it would be levied at the rate of over 79 per cent of appellant's assessable valuation of $94,936.87 rather than at the rate of 15 per cent prescribed by § 54:4-22. Such increased rate of assessment would result solely from appellant's ownership of federal issues. In the *Gehner* case, *supra*, this Court held that § 3701 was offended by a computation which allowed deduction of the full amount of the taxpayer's federal bonds yet at the same time pared down the net value of other allowable exemptions, to the taxpayer's disadvantage, solely because of such ownership of federal bonds. Consistently with the *Gehner* decision, we can only hold that § 3701 is violated by an automatic increase in the rate of assessment applied to appellant's valuation after deduction of federal bonds." 338 U. S. at 674-75.

B. Petitioner's Concept of the Immunity of State and Municipal Bond Interest From Federal Income Taxation Is Not Supported by the Authorities and Examples Cited in Its Brief.

Denman v. *Slayton*, 282 U. S. 514 (1931), and *Helvering* v. *Independent Life Ins. Co.*, 292 U. S. 371 (1934), do not support petitioner. Neither case was cited or referred to in the memorandum submitted by the Treasury Department to the Senate Finance Committee during the hearings or in the Congressional debates on the Act herein involved. Neither case contains the broad holding which petitioner suggests, and both reaffirm the holding in *National Life*.

The expenses for which deductions were denied in *Denman* v. *Slayton* were incurred for the purpose of purchasing tax-exempt securities. The Court recognized that this was "radically different" from *National Life*, where the expenses denied deduction would have been incurred regardless of the receipt of exempt income.[27]

The Court described Slayton's position as follows:

> "Under the theory of the respondent, 'A,' with an income of $10,000 arising from non-exempt securities, by the simple expedient of purchasing exempt ones with borrowed funds and paying

[27] The Court said:

"The circumstances disclosed in *National Life Ins. Co.* v. *United States* were radically different from those now presented, and the doctrine upon which that cause turned does not control the present one. The respondent here was not in effect required to pay more upon his taxable receipts than was demanded of others who enjoyed like incomes solely because he was the recipient of interest from tax-free securities—a result which we found would have followed enforcement of the literal provisions of § 245(a), Revenue Act 1921, 42 Stat. 227, 261." 282 U. S. at 519.

> $10,000 interest thereon, would escape all taxation upon receipts from both sources. It was proper to make provision to prevent such a possibility." 282 U. S. at 519-20.

It is clearly consistent with *National Life* to exclude the $10,000 of interest expense along with the income from the tax-exempt securities. Otherwise a taxpayer could obtain undue tax benefits by purchasing tax-exempt securities with borrowed money.[28] Petitioner's argument here goes much further. It would deny deductions not only for the interest incurred to purchase the exempt securities, but for other expenses to which income from the exempt securities is "allocated" or "apportioned", even though those expenses would have been incurred in any event and would have been fully deductible if no exempt income had been received.

The annual increase in a life insurance company's reserve liabilities to provide for policyholders' claims occurs whether or not the company has taxable investment income, tax-exempt income or any income at all. As such it is an expense of doing business which must be satisfied before there can be any income to be taxed. To disallow a deduction for such an expense because of the receipt of tax-exempt interest would be a radical departure from the policy of exemption long followed by Congress and the courts. The real meaning of the exemption of state and munic-

---

[28] In discussing the illustration at pages 25-6 of its brief, petitioner misconceives respondent's position. Since the interest on the funds borrowed by A to purchase tax exempt bonds would be excluded from the tax computation along with the tax exempt interest in keeping with *Denman v. Slayton*, A's tax would be neither higher nor lower than if it had not bought the tax exempt bonds.

ipal bond interest would be lost, for the economic effect of the denial of deductions is the same as including such interest in gross income. When one such proposal was made in connection with the Revenue Bill of 1924, it was described on the floor of the Senate, where it was rejected, as follows:

> "To say in one breath that a security shall remain untaxed, and in the next breath that deductions shall be allowed on general taxation, but that if a citizen shall hold tax-exempt securities the extent of the reduction shall be diminished by the interest on the obligations of the Government which he holds, is only another way of saying that a tax shall be levied upon these securities." 65 Cong. Rec. 7668 (1924).[29]

Except for the provision of the 1921 Act held invalid in *National Life,* Congress has not taken nor has this Court sanctioned the step which petitioner asks the Court to impute to Congress in this case.

Helvering v. *Independent Life Ins. Co.,* 292 U. S. 371 (1934), a case which involved no question as to the exemption of state and municipal bond interest, applied the same principal as *Denman* v. *Slayton,* and, far from limiting *National Life,* the Court recognized that the problem dealt with in *National Life* was completely different. The Court noted that the only effect

[29] The Revenue Bill of 1926 as passed by the House of Representatives contained a provision like that rejected in 1924 which would have denied deductions for interest not incurred in a trade or business to the extent that the taxpayer received tax-exempt interest income. When this was stricken out by the Senate Finance Committee, the committee commented: "The indirect effect was to impose a tax upon interest which otherwise would be exempt." S. Rep. No. 52, 69th Cong., 1st Sess. 21 (1926).

of the statute in *Independent Life* was to deny deductions for depreciation, taxes and other expenses relating to space occupied by the company in a building owned by it and partly rented to others. At that time such expenses were not deductible by life insurance companies. Only income from investments was taxed, and accordingly only investment expenses were deductible.[30] Since there was no denial of deductions relating to the portion of the building that was rented and which produced rental income, the Court recognized that *Slayton* was applicable and that there was no issue like that in *National Life*. In an opinion by the same Justice who wrote for the Court in *Gehner*, the Court said:

> "Respondent cites *National Life Ins. Co.* v. *United States*, 277 U. S. 508, but the distinction between that case and this one is fundamental and obvious. There the effect of the statutory deduction was to impose a direct tax on the income of exempt securities, amounting to the taxation of the securities themselves . . . In *Denman v. Slayton*, 282 U. S. 514, we held the taxpayer not entitled to deduct the interest on debts incurred to purchase securities the interest on which was exempt. The opinion points out the distinction between that exclusion from deductions and the taxation of exempt securities . . .", 292 U. S. at 381.

Petitioner's example (P. Br. 24-25) of the allocation of automobile expenses between business and personal uses is, like *Independent Life*, only a matter of identifying expenses which are directly attributable

[30] The result is not the same under the present Act, since expenses not allowed as deductions from investment income under Section 804 (c)(3) are deductible under Section 809(d)(12) in computing gain from operations. Petitioner overlooks this at P. Br. 42 n.13.

to more than one use. The portion of the automobile expenses allocated to business use is reduced only if and because the automobile is not actually used for business purposes. It is not reduced if or because the owner of the automobile happens to own some state and municipal bonds from which he receives tax-exempt income, or because he happens to own his own home the rental value of which is not taxed to him as income. Petitioner's failure to recognize this difference between the allocation of expenses which may or may not be deductible depending on how they are identified, which is all there is to its examples at P. Br. 23-24 and 25-26, and the denial of deductions for expenses that are incurred in any event and are denied only because of the receipt of state and municipal bond interest—which is not really "allocation" at all[31]—is the fundamental defect in its whole argument.

Petitioner's discussion of the taxation of trusts (P. Br. 26-27, 30-31) is no more analogous than its automobile expense example, for life insurance companies are not conduits for their policyholders under either state law or Federal tax law. Their reserves reflect liabilities under insurance contracts which are claims against all their assets, and such liabilities increase annually regardless of the nature or amount of income received by them. There is no "fund", nothing is

[31] Petitioner ignores the fact that under the statutory formula all investment expenses are first substracted before there is any "allocation" of investment income between the "policyholders' share" and the "company's share". See Section 804(c). The only true allocation is the assignment of general expenses between investment income and other income as prescribed in Treas. Reg. § 1.804-4(b)(1)(ii).

"set aside" (P. Br. 5), and annual increases in reserve liabilities cannot be identified with actual earnings in any meaningful sense.

The income of life insurance companies is not received in any "dual capacity" (P. Br. 49), for whether the income is from tax-exempt state and municipal bonds, taxable corporate bonds, corporate dividends or any other source affects only the companies. They and they alone are affected by the lower interest rates that state and municipal bonds customarily bear, and if the yield on such bonds is less than the rate at which reserve liabilities increase, it is their responsibility to make up the difference. Thus, cases like *Burnet* v. *Wells*, 289 U. S. 670 (1933); *Reinecke* v. *Smith*, 289 U. S. 172 (1933); and *Corliss* v. *Bowers*, 281 U. S. 376 (1930), holding that the ownership of income may be attributed to the person receiving the economic benefit of it, do not support petitioner's argument in this case.

The statutory description in the Life Insurance Company Income Tax Act of 1959 of a portion of an insurance company's investment income as the "policyholders' share" in order to provide the equivalent of a deduction in respect of increases in reserve liabilities does not take away any rights of the insurance company or confer any upon the policyholders. The policyholders are not taxed on the company's earnings—a result suggested by petitioner's argument which Congress and the Treasury surely did not intend.[32]

[32] The full amount of tax-exempt interest is treated as belonging to the company in the computation of the "phase 3" tax base, despite the "allocation" to the policyholders' share in phases 1 and 2. See Section 815(b)(2)(A)(iii); Treas. Reg. § 1.815-3(d).

Life insurance companies, like corporations generally, are single taxpaying units. No question of allocating income between two or more taxpayers is involved as in the case of trusts. Even regulated investment companies and real estate investment trusts, the only corporate taxpayers given any form of "conduit" treatment under the tax laws, are not permitted to treat their earnings distributed to shareholders as consisting of any earmarked tax-exempt income that the company or trust may receive as such.[33]

C. Petitioner's Interpretation of Sections 804(a)(6) and 809(b)(4) Is Contrary to the Language of Those Sections.

The language of Sections 804(a)(6) and 809(b)(4) by itself negates petitioner's attempt to interpret them as intended only to "forestall" a challenge to the "established" constitutional tax immunity of state and municipal bond interest in the event of a determination that the formula otherwise would result in the imposition of tax on such interest (P. Br. 75-76). In each of these sections, subdivision (B) applies to interest on certain obligations of the United States which interest is exempt from normal taxes under the act authorizing such obligations (see Section 242), and subdivision (C) applies to dividends received from other corporations for which certain deductions are allowed under Sections 243-245. Obviously, the partial Federal tax exemption of obligations issued by the Federal government has no relation to the constitutional problem of Federal taxa-

[33] See Compendium of Papers on Broadening the Tax Base Submitted to the House Ways and Means Committee, 86th Cong., 1st Sess. 1658-70 (1959).

tion of interest on state and municipal bonds, nor does the power of Congress to limit or even deny completely the deduction or partial exemption for intercorporate dividends, which would not seem to raise a constitutional problem at all.

Petitioner's additional claim (P. Br. 12, 20-24) that income must, by a process of "allocation", be matched with deductions before it can be determined whether there is a "tax on" state and municipal bond interest within the meaning of the adjustment clauses ignores the fact that the exemption of state and municipal bond interest provided throughout the history of the Federal income tax has been an exclusion from gross income. The only reasonable reading of the adjustment clauses, which refer to a "tax on . . . any interest which under Section 103 is excluded from gross income. . . .", is that Congress intended for life insurance companies to have the same exemption. Petitioner's semantic argument focusing on the words "tax on" by themselves is simply beside the point here where the exemption being protected is an exclusion from gross income.

Respondents' tax liability, as determined by petitioner, is increased solely because state and municipal bond interest is included in "gross investment income".[34] It is this increase that the adjustment clauses are designed to eliminate.

---

[34] In terms of the definitions contained in the statute, "investment yield" is "gross investment income" less certain deductions connected with investment income. Section 804(c). State and municipal bond interest is included in "gross investment income" (see Treas. Reg. § 1.804-3(a)(1)(i)), and thus it increases "investment yield". Each item of "investment yield" is then divided between the "policyholders' share" exclusion and the amount taxed to the company as the "company's share". The division is made on the basis of percentages

Where the adjustment clauses apply, the basic exemption of state and municipal bond interest afforded to other taxpayers under Section 103 is preserved for life insurance companies by excluding such interest from gross income throughout the tax computation, as the Court of Appeals directed.[35] Thus state and municipal bond interest was excluded both from "investment yield" in arriving at the percentage of investment income taxed to the company as the "company's share" and from the computation of the earnings rates used in arriving at "policy and other contract liability requirements" under phase 1, the only other place where such interest entered into the tax computation.[36]

---

arrived at by dividing "investment yield" into "policy and other contract liability requirements" in phase 1 and "required interest" in phase 2. Sections 804(a)(1), 809(a)(1). Since the latter amounts remain relatively fixed, the increase in "investment yield" resulting from the inclusion of state and municipal bond interest decreases the percentage of investment income excluded as the "policyholders' share" and increases the amount taxed to the company as the "company's share". The percentage thus determined is applied to each and every item of investment income included in "investment yield" (§§ 804(a)(1), 809(a)(1)), and thus a larger portion of both the taxable and nontaxable items of income is included in the "company's share" as a result of this computation. The tax-exempt income included in the "company's share" is then deducted (§§ 804(a)(2)(A)(i), 809(d)(8)(A)(i)), but the increase in the amount of the taxable items of income taxed to the company is not removed in any subsequent steps in the computation, and unless the adjustment clauses are applied the increase is included in "taxable investment income" and "gain from operations" and the ultimate amount of the tax is increased.

[35] A comparative analysis of the computation of the tax collected from respondent and of the tax computed with the adjustments ordered by the Court of Appeals is set forth in Appendix B at pp. 64-76.

[36] The "policyholders' share" exclusion under phase 1 is equal to "policy and other contract liability requirements", as defined in Section 805. Under that section, reserve liabilities are recomputed pursuant to an actuarial formula designed to restate the reserves as they

The exclusion of such interest from earnings rates had the effect of reducing the amount excluded as the "policyholders' share" in phase 1. Thus, while 85.3364% of respondent's state and municipal bond interest, or $31,265.37, is "allocated" to the "policyholders' share" in petitioner's computation of "taxable investment income", the adjustment ordered by the Court of Appeals reduced the "policyholders' share" and hence respondent's "taxable investment income" by only $11,258.64. The remaining $20,006.73 is the decrease in "policy and other contract liability requirements" resulting from the lower earnings rates with state and municipal bond interest excluded. Thus the adjustments did not have the effect described by petitioner (P. Br. 10) of "allocating" all such inter-

---

would appear if they had been built upon the basis of the company's actual earnings experience instead of assumed interest rates. The recomputed reserves, called "adjusted life insurance reserves", are then multiplied by the "adjusted reserves rate", which is the lower of the earnings rate for the current year or the average of the earnings rates for the current year and the preceding four years. Thus the reduction in earnings rates resulting from the exclusion of state and municipal bond interest from their computation lowers the amount determined to be "policy and other contract liability requirements".

The bonds themselves were not excluded from assets in determining earnings rates but were treated in effect as assets which produced no income, like idle bank accounts. Exclusion of such bonds from assets would have increased earnings rates, thereby conferring an undue benefit by reducing the tax on the taxable items of investment income. The adjustments ordered by the Court of Appeals are neutral with respect to investment in state and municipal bonds.

In phase 2 the "policyholders' share" exclusion is equal to "required interest", which is determined by multiplying the company's reserve liabilities by the interest rates assumed by the company in calculating increases in its reserve liabilities for state reporting purposes. "Required interest" is not affected by earnings.

est to the company and "allocating" only taxable items of income to the amount excluded or deducted as the "policyholders' share". On the contrary, it made the deduction for reserve liability increases neutral with respect to the receipt of interest on state and municipal bonds.

Sections 804(a)(6) and 809(b)(4) are exceptions, plainly labeled as such, which apply only where the tax would be increased as a result of the inclusion of state and municipal bond interest in gross income. If no increase in tax results, the exemption of state and municipal bond interest is not impaired by the inclusion of such interest in the tax computation. This may occur, for example, in the case of companies with a low ratio of reserves to assets and an investment yield of less than $250,000 for which the small business deduction equal to 10 percent of investment yield (§§ 804(a)(4), 809(d)(10)) may be larger than the increase in the taxable items of investment income taxed to them that results when the larger "investment yield" is used to determine the "policyholders' share" exclusion.[37] Thus the adjustment clauses do not apply in every case, as petitioner claims (P. Br. 57), and the result would not have been the same in all cases if Congress had eliminated tax-exempt interest from the formula altogether (*cf.* P. Br. 57).

---

[37] See The National Underwriter, March 6, 1965, p. 22. The study reported in this article did not cover most of the smaller companies where this result would occur, although some instances were found among the companies that were studied.

Even if adjustments had to be made in every case where state and municipal bond interest is received, the statutory formula would not be rendered inoperative. The detailed provisions of the Life Insurance Company Income Tax Act of 1959 apply to all aspects of the taxation of life insurance companies. Congress did considerably more than devise a formula affecting only tax-exempt interest. It provided a basic change in the method of taxing life insurance companies, and this change is effective even if tax-exempt interest, which normally is a relatively small portion of a life insurance company's income,[38] is eliminated from the tax computation under the adjustment clauses. The sole purpose in enacting the adjustment clauses was to ensure that the major changes being made in the statute would not adversely affect the basic exemption of state and municipal bond interest and the other items of income to which they apply. With a tax at a marginal rate of 29.1% applicable to the receipt of state and municipal bond interest, the record in this case shows that fully taxable corporate bonds with their higher interest rates would be a more attractive investment to respondent under normal market conditions (R. 44-45.)

---

[38] The study reported in The National Underwriter, March 6, 1965, p. 22, found that there would be no inducement for companies paying 90 percent of the tax paid by the life insurance industry to increase their investment in state and municipal bonds if interest on such bonds were eliminated by the adjustments from the computation of their Federal income tax liability.

Only 2.8% of the assets of United States life insurance companies was invested in state and local bonds in 1958; in 1963, the figure was 2.7%. Institute of Life Insurance, *Life Insurance Fact Book 1964*, p. 73.

Conclusion

The repeated assurances in the committee reports and the legislative debates that state and municipal bond interest would not be taxed under the bill containing the adjustment clauses leave no doubt that Congress intended to preserve the immunity of state and municipal bond interest from Federal taxation as traditionally understood by all. It was made unmistakably clear in the hearings before the Senate Finance Committee which added the adjustment clauses to the bill that the immunity which was to be protected was the immunity that was given effect in *National Life*. Congress did not intend that the traditional immunity enjoyed by state and municipal bonds should be "chipped away" and destroyed by the disallowance of deductions or by the use of a sophisticated formula for dividing a life insurance company's income between the "policyholders' share" and the "company's share", the operation of which would vary with the receipt of state and municipal bond interest.

Sections 804(a)(6) and 809(b)(4) were added by Congress to ensure that interest on state and municipal bonds would continue to enjoy their full immunity from Federal taxation in the hands of life insurance companies. This can be done only if, as determined by the Court below, the adjustment clauses are interpreted in accordance with Congressional intent and invoked to eliminate any increase in tax that would result from the receipt of state and municipal bond interest by life insurance companies.

The decision of the United States Court of Appeals for the Tenth Circuit should be affirmed.

Respectfully submitted.

NORRIS DARRELL
Attorney for Respondent
48 Wall Street
New York, New York 10005

M. BERNARD AIDINOFF
KENDYL K. MONROE
SULLIVAN & CROMWELL
48 Wall Street,
New York, New York 10005

DICKSON M. SAUNDERS
DOERNER, STUART, MORELAND
& SAUNDERS
1218 Atlas Life Building
Tulsa, Oklahoma 74111

BYRON V. BOONE
BOONE & ELLISON
914 World Building
Tulsa, Oklahoma 74111

THOMAS C. THOMPSON, JR.
SCRIBNER, HALL & CASEY
1209 Ring Building
Washington, D. C. 20036

APPENDIX A

THE TAXATION OF LIFE INSURANCE COMPANIES

Under Section 802(a) of the Internal Revenue Code of 1954, added by the Life Insurance Company Income Tax Act of 1959, a tax is imposed at ordinary corporate rates on the "life insurance company taxable income" of companies subject to the Act. The determination of "life insurance company taxable income" as defined in Section 802(b) involves three separate computations, which are often referred to as phases 1, 2 and 3. In addition, long-term capital gains are taxed separately.

The phase 1 computation determines "taxable investment income" and starts with a calculation of "investment yield". "Investment yield" is defined as gross investment income less investment expenses. Section 804(c). Gross investment income includes interest (whether taxable, partially tax-exempt, or fully tax-exempt), dividends, rents, royalties and other investment-type income. Section 804(b). Investment expenses include general investment expenses (subject to certain limitations) and other expenses not attributable to insurance business. Section 804(c).

"Investment yield" is next divided into two shares, the "company's share" and the "policyholders' share". The "policyholders' share" is excluded and only the "company's share" of "investment yield" is included in "taxable investment income". Sections 804(a)(1) and (2). The "policyholders' share" is a percentage determined by dividing "investment yield" into the

"policy and other contract liability requirements". Section 804(a)(1).

"Policy and other contract liability requirements" is determined under the complex formulae provided in Section 805 by multiplying the company's "adjusted life insurance reserves" by the "adjusted reserves rate", which is the lower of its current earnings rate or its average earnings rate for the current year and the four preceding years; in addition, pension plan reserves are multiplied by the current earnings rate and there is added the interest paid during the year. Section 805(a). The earnings rates used in this computation are determined by dividing "investment yield" for each year by the mean of the company's assets for such year. Section 805(b). The company's "adjusted life insurance reserves" are its life insurance reserves required by law, other than pension plan reserves, adjusted for the difference between the assumed interest rate used in computing such reserves and the company's actual earnings rate. The reserves are adjusted upward by one percent for every tenth of a percent by which the "adjusted reserves rate" is less than the assumed rate; if the "adjusted reserves rate" exceeds the assumed interest rate, the reserves are adjusted downward in a similar manner. Section 805(c). In these computations, a reduction in the "adjusted reserves rate" because of a smaller "investment yield" results in an upward adjustment in arriving at "adjusted life insurance reserves".

The general purpose of these computations is to determine the amount which, on the basis of the com-

pany's own investment experience, is need to satisfy its liabilities on its insurance contracts.

After the "policyholders' share" percentage is determined by dividing "investment yield" into "policy and other contract liability requirements", the remaining portion of 100% is the "company's share". Section 804(a)(2). Thus if "investment yield" increases relative to "policy and other contract liability requirements", the "company's share" percentage increases; if "investment yield" decreases, the "company's share" percentage decreases, but it is never below zero. The "company's share" percentage is then applied to "investment yield" to determine the portion of investment income that is included in "taxable investment income". Section 804(a)(2). The effect is to include in the company's taxable income only the amount of "investment yield" in excess of the "policy and other contract liability requirements." The final computation in determining "taxable investment income" is to deduct from the company's share of "investment yield" its share of tax-exempt interest, deductions for partially tax-exempt interest and dividends received in respect of its share of such items, and finally a small business deduction. Section 804(a)(2).

Section 804(a)(6) provides that if it is established in any case that the foregoing computation of "taxable investment income" results in the imposition of tax on any tax-exempt interest, or on certain other items, an adjustment shall be made to the extent necessary to prevent such imposition.

The phase 2 computation determines "gain from operations" under Section 809. The "company's share" and the "policyholders' share" percentages are computed in the same manner as in phase 1, except that "investment yield" is divided into "required interest" instead of "policy and other contract liability requirements". Sections 809(a)(1) and (b)(3). "Required interest" is determined by multiplying the company's reserves by the assumed interest rates used by the company in computing its reserve liabilities. Section 809(a)(2). "Required interest" is thus the amount that the company assumes it must earn from its investments in order to meet the annual increases in its contractual liabilities to policyholders. After the "company's share" percentage is determined, it is, as in phase 1, applied to "investment yield". Section 809(b)(1). The amounts thus determined are then added to premium receipts and other income, and there are deducted claims, increases in certain reserves,* regular corporate expenses, the company's share of tax-exempt interest, deductions for partially tax-exempt interest and dividends received in respect of the company's share of such items, the small business deduction, and other special deductions. Section 809(d). The special deductions, which relate to policyholder dividends on participating insurance policies and special allowances for nonparticipating policies and group insurance, cannot reduce "gain from operations" to an amount that is smaller than "taxable

* The deduction for increases in reserves is reduced by the amount of the "policyholders' share" percentage of "investment yield not included in gain or loss from operations". Sections 810(a) and (b).

investment income" by more than $250,000. Section 809(f).

As in phase 1, if it is established in any case that this computation of "gain from operations" results in the imposition of tax on tax-exempt interest or certain other items, an adjustment is required to prevent such imposition. Section 809(b)(4).

Where "gain from operations" determined under phase 2 exceeds "taxable investment income" determined under phase 1, 50 percent of such excess is added to "taxable investment income" in computing "life insurance company taxable income". Section 802(b)(1) and (2). If "gain from operations" is less than "taxable investment income", only "gain from operations" is included in "life insurance company taxable income" and "taxable investment income" is ignored. Section 802(b)(1).

The phase 3 computation is designed to include in "life insurance company taxable income" after 1958 the 50 percent of the excess of "gain from operations" (phase 2) over "taxable investment income" (phase 1) which has not been included in "life insurance company taxable income" at the time it was earned. Section 815. It is not applicable in this case.

The regular 52 percent corporate tax is imposed on "life insurance company taxable income" (with the 30 percent rate applying to the first $25,000). Section 802(a)(1). A separate 25 percent tax is imposed with respect to net long-term capital gains in excess of net short-term capital losses. Section 802(a)(2).

APPENDIX B

ADJUSTMENTS ORDERED BY THE COURT OF APPEALS

A step-by-step comparison of petitioner's computation of respondent's tax liability and the computation of respondent's tax liability after making the adjustment excluding state and municipal bond interest as ordered by the Court of Appeals may be found at the end of this appendix. The computation may be summarized as follows (parenthetical references are to the comparison):

In petitioner's computation, to arrive at a "company's share" percentage of 14.6636% in "phase 1", petitioner divided "investment yield" of $894,277.61, which included respondent's state and municipal bond interest of $36,637.79, into "policy and other contract liability requirements" in the amount of $763,144.28, and subtracted the result from 100%. (Phase 1, items 7 and 8.) Disregarding respondent's tax-exempt interest in this computation, as the Court of Appeals ordered, "investment yield" is reduced to $857,639.82. (Phase 1, item 1.) Dividing that amount into "policy and other contract liability requirements", which is reduced to $743,137.55 because of the lower earnings rates resulting from the exclusion of tax-exempt interest from the determination of such rates, the "company's share" percentage is 13.3509%. (Phase 1, item 8.) Thus, 1.3127% of the 14.6636% determined by petitioner was attributable to respondent's tax-exempt interest. Petitioner applied 14.6636% to both the taxable and tax-exempt items of

respondent's "investment yield", thereby determining that $125,760.87 of the taxable items and $5,372.42 of the tax-exempt items or a total of $131,133.29 of "investment yield" were includible in "taxable investment income" before deducting tax-exempt interest. (Phase 1, item 9.) Both of these amounts were directly increased by the use of the 14.6636% "company's share" percentage instead of 13.3509%. Petitioner then deducted the $5,372.42 of tax-exempt interest, but the $125,760.87 was included in "taxable investment income" without any modification for the increase of $11,258.60 of taxable items of "investment yield" included in "taxable investment income" solely because of the 1.3127% increase in the "company's share" percentage resulting from the inclusion of tax-exempt interest in "investment yield". (Phase 1, item 10.) If 13.3509%, the percentage determined without regard to tax-exempt interest, is used, the amount of "investment yield" taxable to respondent is $114,502.27, and after the small business deduction respondent's "taxable investment income" is $89,502.27 instead of $100,760.87 as determined by petitioner. (Phase 1, items 9 and 11.)

In the adjustments ordered by the Court of Appeals, the exclusion of tax-exempt interest from "investment yield" in determining the earnings rates in phase 1 resulted in a reduction of the "policy and other contract liability requirements".* If tax-exempt interest had

* Tax-exempt securities were not excluded from respondent's assets in determining the earnings rates. This would unduly increase earnings rates thereby reducing the tax on the taxable items of respondent's investment income.

not been excluded from this computation, the "company's share" percentage in phase 1 would have been further reduced from 13.3509% to 11.0181% (instead of the 14.6636% used by petitioner), and the difference in tax liability would have been even greater. By eliminating tax-exempt interest in the computations of earnings rates, the Court of Appeals has removed any advantage that might accrue in the computation of "policy and contract liability requirements" by reason of the receipt of tax-exempt interest and achieved exactly the same result as if respondent had received no earnings attributable to tax-exempt securities in 1958 or in prior years. (Phase 1, items 2-5.)

In the phase 2 computation petitioner also included tax-exempt interest in "investment yield" in determining the "company's share" percentage, and this again resulted in increasing the amount of investment income taxed to respondent. In phase 2, the percentage is obtained by dividing "investment yield" into "required interest", which was $781,540.32, and subtracting the result from 100%. Petitioner again used "investment yield" with tax-exempt interest included, or $894,277.61, as the denominator and thus determined that the "policyholders' share" percentage was 87.39348% and the "company's share" percentage was 12.60652%. (Phase 2, items 3 and 4.) If the percentage is determined without regard to tax-exempt interest, as the Court of Appeals ordered, the "company's share" percentage is 8.8731%. (Phase 2, item 4.) Thus 3.7334% of the 12.60652% used by petitioner is attributable to respondent's tax-exempt interest.

Petitioner used 12.60652% to determine that the "investment yield" includible in respondent's "gain from operations" was $108,118.54. (Phase 2, item 5(b).) If the percentage determined without regard to tax-exempt interest (8.8731%) is used, the company's share of "investment yield" is $76,099.50, and respondent's "gain from operations" is $129,201.04 instead of $161,220.08 as determined by respondent. (Phase 2, items 5(b) and 7.) This is the same "gain from operations" that respondent would have had if it had received no tax-exempt interest.

Respondent's tax liability was determined by the Court of Appeals by adding to the "taxable investment income" of $89,502.27, 50% of the amount by which the "gain from operations" of $129,201.04 exceeds the "taxable investment income" to arrive at a "life insurance company taxable income" of $109,351.66. (Tax computation, item 1.) The tax on this amount is $51,362.86. (Tax computation, item 2.) These figures compare with petitioner's determinations that respondent's "taxable investment income" was $100,760.87, its "gain from operations" $161,220.08, its "life insurance company taxable income" $130,990.48, and its tax liability $62,615.05. (Tax computation, items 1 and 2.) The difference in tax liability of $11,252.19 is the tax imposed on state and municipal bond interest which the Court of Appeals determined should be refunded to respondent.

COMPARATIVE ANALYSIS OF EXHIBITS 6 AND 7

Following is a step-by-step comparison of plaintiff's Exhibit 6 (R. 35, 66-72), which shows petitioner's computation of respondent's income tax liability for 1958 in which tax-exempt interest is taken into account, and plaintiff's Exhibit 7 (R. 39, 73-79), which shows the computation of the refund claimed by respondent and ordered by the Court of Appeals in which tax-exempt interest is disregarded.

Phase 1: Computation of Taxable Investment Income:

Item	Exhibit 6	Exhibit 7	Code Section and Line on Tax Return	Explanation
1. Investment Yield	$894,277.61	$857,639.82	804(e); Sch. A, Ln. 14	Investment yield is gross investment income after deducting investment expenses. Investment yield in Ex. 7 is lower than that in Ex. 6 due to the exclusion of $36,637.79 of tax-exempt interest accrued by respondent in 1958.
2. Current Earnings Rate	3.33390%	3.19731%	805(b)(2); Sch. B, Pt. III, Ln. 1	Current earnings rate equals investment yield in Item 1 divided by assets. The lower investment yield in Ex. 7 thus reduces the current earnings rate.
3. Average Earnings Rate	3.253782%	3.12297%	805(b)(3); Sch. B, Pt. III, Ln. 7	Average earnings rate is the average of the current year's earnings rate and that of the prior four years.

COMPARATIVE ANALYSIS OF EXHIBITS 6 AND 7 (Continued)

Phase 1: Computation of Taxable Investment Income (continued):

Item	Exhibit 6	Exhibit 7	Code Section and Line on Tax Return	Explanation
4. Adjusted Reserves Rate	3.253782%	3.12297%	805(b)(1); Sch. B, Pt. I, Ln. 2, Left Col.	The adjusted reserves rate is the lower of Item 2 or Item 3 above.
5. Adjusted Life Insurance Reserves	$22,090,965.28	$22,375,659.00	805(c); Sch. B, Pt. V, Ln. 3	Adjusted life insurance reserves is the amount of reserves required by law adjusted upward by 1% for every .1% by which the assumed interest rate used in calculating such reserves exceeds the adjusted reserves rate. The adjustment is greater in Ex. 7 because the lower earnings rates, by decreasing the adjusted reserves rate, increase the difference between the adjusted reserves rate and the assumed interest rate.
6. Policy and Other Contract Liability Requirements	$763,144.28	$743,137.55	805(a); Sch. B, Pt. I, Ln. 4	This amount is computed by multiplying the adjusted life insurance reserves by the adjusted reserves rate and adding the interest paid by the company during the year. A lower

COMPARATIVE ANALYSIS OF EXHIBITS 6 AND 7 (Continued)

Phase I: Computation of Taxable Investment Income (continued):

Item	Exhibit 6	Exhibit 7	Code Section and Line on Tax Return	Explanation
				amount results in Ex. 7 because of the reduction in the adjusted reserves rate in Item 4 resulting from the lower earnings rates because of the exclusion of tax-exempt interest from investment yield. The effect of the reduction in the adjusted reserves rate is partially offset by the increase in adjusted life insurance reserves in Item 5.
7. Policyholders' Share Percentage	85.3364%	86.6491%	804(a)(1); Sch. C, Ln. 1	This percentage is obtained by dividing investment yield into the policy and other contract liability requirements. The percentage is smaller in Ex. 6 because tax-exempt interest is included in investment yield, despite the lower amount of policy and other contract liability requirements in Ex. 7.
8. Company's Share Percentage	14.6636%	13.3509%	804(a)(2); Sch. C, Ln. 2	This percentage equals 100% minus the policyholders' share

COMPARATIVE ANALYSIS OF EXHIBITS 6 AND 7 (Continued)

Phase 1: Computation of Taxable Investment Income (continued):

Item	Exhibit 6	Exhibit 7	Code Section and Line on Tax Return	Explanation
				percentage in Item 7. A comparison of Exs. 6 and 7 here shows that the inclusion of tax-exempt interest in Ex. 6 results in increasing the company's share percentage.
9. Company's Share of Items of Investment Yield			804(a)(2); Sch. C, Lns. 4-8	The larger company's share percentage in Item 8 results in allocating to respondent a larger amount of taxable items of investment yield. The total figure may also be obtained by subtracting the policy and other contract liability requirements from the investment yield.
(a) Tax-Exempt Interest	$ 5,372.42	None		
(b) Other Items	125,760.87	$114,502.27		
(c) Total	$131,133.29	$114,502.27		
10. Deduction for Tax-Exempt Interest	$ 5,372.42	None	804(a)(2)(A)(i); Sch. C, Ln. 9	In Ex. 6 deduction is taken for the company's share (14.6636%) of the tax-exempt interest ($36,637.79) included in investment yield. No amount is deducted in Ex. 7 since all the tax-exempt in-

COMPARATIVE ANALYSIS OF EXHIBITS 6 AND 7 (Continued)

Phase 1: Computation of Taxable Investment Income (continued):

Item	Exhibit 6	Exhibit 7	Code Section and Line on Tax Return	Explanation
				terest has been initially excluded from investment yield.
11. Taxable Investment Income	$100,760.87	$ 89,502.27	804(a)(2); Sch. C, Ln. 14	This figure is obtained by deducting the $25,000.00 small business deduction and Item 10 from Item 9(c).

The difference of $11,258.60 in taxable investment income between Ex. 6 and Ex. 7 is attributable to the difference in the company's share percentage in Item 8 (1.3127%) multipled by the amount of the taxable items of investment yield ($857,639.82). The higher company's share percentage in Ex. 6 results from the inclusion of tax-exempt interest in investment yield in Item 1. The inclusion of tax-exempt interest in investment yield in Ex. 6 affects taxable investment income in two ways:

A. The entire $36,637.79 of tax-exempt interest is included in investment yield, and only $5,372.42 is deducted, increasing taxable investment income by	$31,265.37
B. Since earnings rates are higher with tax-exempt interest included, the policy and other contract liability requirements is higher in Ex. 6 than in Ex. 7 thus decreasing taxable investment income by	20,006.73
The netting of A. and B. results in a net increase in taxable investment income of	$11,258.64

This amount differs slightly from the difference of $11,258.60 above because of rounding in the computation of taxable investment income.

COMPARATIVE ANALYSIS OF EXHIBITS 6 AND 7

Phase 2: Computation of Gain from Operations:

Item	Exhibit 6	Exhibit 7	Code Section and Line on Tax Return	Explanation
1. Investment Yield	$894,277.61	$857,639.82	804(c); Sch. A, Ln. 14	See Item 1 of the computation of taxable investment income.
2. Required Interest	$781,540.32	$781,540.32	809(a)(2); Sch. E-1, Ln. 5	Required interest is the average rate of interest assumed by respondent in calculating its 1958 reserve liability increases.
3. Policyholders' Share Percentage	87.39348%	91.1269%	809(a)(1); Sch. E, Ln. 1	This percentage is obtained by dividing the required interest by investment yield. The percentage is smaller in Ex. 6 because tax-exempt interest is included in investment yield.
4. Company's Share Percentage	12.60652%	8.8731%	809(b)(3); Sch. E, Ln. 2	This percentage equals 100% minus the policyholders' percentage obtained in Item 3. A comparison of Exs. 6 and 7 here demonstrates that the inclusion of tax-exempt interest in Ex. 6 results in increasing the company's share percentage, just as in Item 8 of the computation of taxable investment income.

COMPARATIVE ANALYSIS OF EXHIBITS 6 AND 7 (Continued)

Phase 2: Computation of Gain from Operations (continued):

Item	Exhibit 6	Exhibit 7	Code Section and Line on Tax Return	Explanation
5. Company's Share of Items of Investment Yield			809(b)(1); Sch. E, Lns. 4-8	The larger company's share percentage in Item 4 results in allocating to respondent a larger amount of taxable items of investment yield. The total figure also can be obtained by subtracting required interest from investment yield.
(a) Tax-Exempt Interest	$ 4,618.75	None		
(b) Other Items	108,118.54	$76,099.50		
(c) Total	$112,737.29	$76,099.50		
6. Deduction of Tax-Exempt Interest	$ 4,618.75	None	809(d)(8)(A)(i); Sch. E, Ln. 16	In Ex. 6 a deduction is allowed for the company's share (12.60652%) of the tax-exempt interest ($36,637.79) included in investment yield. No amount is deducted in Ex. 7 since all tax-exempt interest has been initially excluded from investment yield.
7. Gains from Operations	$161,220.08	$129,201.04	809(b)(1); Sch. E, Ln. 27	The difference of $32,019.04 in gain from operations between Ex. 6 and Ex. 7 is attributable

COMPARATIVE ANALYSIS OF EXHIBITS 6 AND 7 (Continued)

Phase 2: Computation of Gain from Operations (continued):

Item	Exhibit 6	Exhibit 7	Code Section and Line on Tax Return	Explanation
				to the difference in the company's share percentages in Item 4 (3.7334%) multiplied by the taxable items of investment yield ($857,639.82). The higher company's share percentage in Ex. 6 is attributable entirely to the inclusion of tax-exempt interest in investment yield in Item 1. The difference is also exactly equal to the difference between the tax-exempt interest of $36,637.79 included in investment yield in Item 1 and the $4,618.75 deducted in Item 6 as the company's share of tax-exempt interest.

COMPARATIVE ANALYSIS OF EXHIBITS 6 AND 7 (Continued)

Tax Computations

Item	Exhibit 6	Exhibit 7	Code Section and Line on Tax Return	Explanation
1. Life Insurance Company Taxable Income	$130,990.48	$109,351.66	802(b); Pg. 1, Ln. 3	This figure is the sum of the entire amount of taxable investment income and 50% of the excess of gain from operations over taxable investment income.
2. Total Income Tax	$ 62,615.05	$ 51,362.86	802(a); Pg. 1, Ln. 6	This amount is respondent's tax liability for 1958. Ex. 6 shows the tax liability after making the corrections on the respondent's original 1958 return agreed to by the parties but without making adjustments to prevent the imposition of tax on tax-exempt interest. Ex. 7 shows respondent's 1958 tax liability after making the adjustments under Secs. 804(a)(6) and 809(b)(4) ordered by the Court of Appeals. The difference between the tax liability on Ex. 6 and that on Ex. 7 is $11,252.19 and represents the increased tax liability for 1958 if tax-exempt interest is not entirely excluded from the tax computation.

In the Supreme Court of the United States

OCTOBER TERM, 1964

No. 489

UNITED STATES OF AMERICA, PETITIONER

v.

ATLAS LIFE INSURANCE COMPANY

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT

REPLY BRIEF FOR THE UNITED STATES

I

The respondent and the *amici* have urged that Congress did not intend, in 1959, to reduce the incentive of life insurance companies to buy tax-exempt bonds, and that therefore the "exception" provisions of the 1959 Act should be construed in a way that wholly vitiates the allocation formula of the same Act. We challenge the representation that our interpretation reduces the incentive in comparison with the 1942 statute. The fact of the matter is that the enactment of the 1959 statute increased, rather than reduced, the incentive of life insurance

768-356—65

companies to buy tax-exempt bonds. Congress was fully informed, prior to the enactment of the statute, that this would be its likely effect. History has demonstrated the accuracy of that prediction.

Mr. David Lindsay, Assistant to the Secretary of the Treasury, informed the Senate Committee by memorandum that (*Senate Hearings* at p. 50):

> Since the effective rate of tax under H.R. 4245 is generally higher than under present law (with exceptions and variations depending upon the circumstances of individual companies) the value of the tax-exempt feature of municipal securities in the hands of life insurance companies would generally be greater under the bill than under present law. The attractiveness of municipal securities to life insurance companies as a whole should accordingly be enhanced and the market for such securities to that extent should be greater.

His prediction has proved true to a rather dramatic extent.

Respondent and the *amici* have referred to statistics found in the *Life Insurance Fact Book of 1964*, a publication of the Institute of Life Insurance. The following chart is complied from pages 65 and 73 of the *Fact Book*, and shows that the life insurance industry's holdings of tax-exempt State bonds increased radically in the five calendar years ending after the enactment of the 1959 Act (on June 25, 1959). The increase is equally dramatic whether measured in terms of total volume of holdings, percentage increase in volume of holdings, or percentage increase in the

share of the industry's assets held in the form of municipal bonds.

Year	Total assets of United States life insurance companies at end of calendar year	Total dollar amount of State bonds owned by United States life insurance companies	Percentage of assets held in form of State bonds
1954	$84,486,000,000	$1,846,000,000	2.2
1955	90,432,000,000	2,038,000,000	2.3
1956	98,011,000,000	2,273,000,000	2.4
1957	101,309,000,000	2,376,000,000	2.3
1958	107,580,000,000	2,681,000,000	2.5
1959	113,650,000,000	3,200,000,000	2.8
1960	119,576,000,000	3,588,000,000	3.0
1961	126,816,000,000	3,888,000,000	3.1
1962	133,291,000,000	4,026,000,000	3.0
1963	141,121,000,000	3,852,000,000	2.7

The average of life insurance company holdings of State bonds for the five years ending before the enactment of the 1959 Act is $2,242,800,000. For the five years following enactment of the statute, the average increased by almost one and one-half billion dollars to $3,710,800,000. This change represented a 65-percent increase in the holding of municipal bonds over a five-year period while total assets increased only 32 percent (from an average of $95,964,000,000 to an average of $126,891,000,000). During the same years, the portion of assets held in State bonds increased by approximately 26 percent from 2.3 percent to 2.9 percent. While this increase in bondholdings was, to a large extent, a continuation of a gradual process begun before 1959, the statistics rather plainly show a significantly accelerated increase beginning in that year.

Mr. Lindsay's accurate prediction was based on a comparison of the 1942 taxing statute with the 1959

Act. See *Senate Hearings* at 50. Under the 1942 Act, an insurance company was allowed a reserve deduction equal to a fixed percentage of its net *taxable* income. 56 Stat. 867–870. In the years from 1942 to 1957 the deduction was always in excess of 85 percent of taxable income, generally in excess of 90 percent, and, for two years, was 100 percent. See Wurzel, *Tax Exempt Interest of Life Insurance Companies*, 70 Yale L. J. 15, 20–21. The result was that a life insurance company generally had no reason to shift a larger part of its investment to the tax-free, lower-return municipal bonds in place of other taxable, higher-return securities. For example, a company deciding between a corporate bond paying 4.5 percent and a municipal bond paying 3.5 percent would realize that it would be allowed a reserve deduction of approximately 90 percent of the return on the corporate bond, but no reserve deduction on the municipal bond. It would be left with an *after-tax* return of over 4 percent on the corporate bond in contrast to the 3.5 percent after-tax return on the municipal bond. In short, since the reserve deduction under the 1942 Act was a fraction of *taxable* income, a taxpayer could gain the 100-percent exemption of interest from State bonds only by giving up the 90-percent reserve exemption of income from corporate stock or bonds.

The situation under the 1959 Act is, in principle, identical. An insurance company is allowed a reserve exemption measured by a percentage—usually quite high—of its taxable investment income. Just as under the 1942 Act, an insurance company can obtain

the benefits of 100-percent tax-free State bonds only by foregoing the advantage of the high percentage exemption from tax (in this case 87.4 percent) of the return from taxable securities.

The only difference between the 1942 Act and the 1959 Act is the method of computing the percentage of taxable income which is entitled to a reserve exemption. The percentage was determined under the 1942 Act on an industry-wide basis by a statutory formula; it was reduced by the industry holdings of tax-exempt bonds, but still generally resulted in an exceedingly high reserve deduction. Under the 1959 Act the percentage is determined on a single-company basis by dividing each company's total investment income (taxable and tax-exempt) into its reserve requirements. The enactment of the 1959 Act could deter the purchase of State bonds only if the percentage of taxable income allowed a reserve exemption from tax proved greater under that Act than under the 1942 Act. In light of the extraordinarily high percentages arrived at under the 1942 Act, this appeared unlikely from the start. In fact, the 1959 Act has apparently increased the incentive to buy tax-exempt bonds, by reducing for most companies the reserve exemption of taxable income. The result has been the remarkable increase in holdings of State bonds, which is revealed by the above chart, taking place during a period when the life insurance companies have assumed the applicability of the statutory allocation formula. The present case, initiated almost three years after the enactment of the 1959 Act, marks

the first occasion when any company has challenged the applicability of that formula.

Two conclusions follow, both directly contradictory of respondent's representations:

First, there was nothing novel in limiting the deduction for the addition to the reserve to the portion of the actual addition reflecting the extent of investment in taxable securities. This has been accomplished since 1942 by making the reserve deduction a fraction of an insurance company's taxable income, thus reducing the deduction to the extent the company's investments are in tax-exempt bonds rather than taxable securities.

Second, the 1959 Act did not adversely affect the insurance companies' demand for tax-exempt bonds.[1]

II

A. Respondent contends that the proper method by which to determine whether the apportionment formula imposes a tax on its tax-exempt interest is to compare its tax determined under the formula with what its tax would have been if it had not received

[1] Both respondent and the *amici* have exercised remarkable selectivity in referring to the figures for insurance company holdings of State bonds. *Amici* first suggest a downtrend in the portion of company assets invested in State bonds by comparing year-end figures for 1963 with those for 1959 (Am. Br. 16, n. 1), ignoring the facts: (1) that both dates are well after, and reflect the effects of, the enactment of the 1959 Act in June 1959; (2) that on December 31, 1960, 1961, and 1962, the share of investments was substantially higher than on December 31, 1959; and (3) that for *each* of the five years after enactment of the 1959 Act, the share was significantly greater than for *any* of the five years preceding enactment. Respondent avoids these difficulties only because it mistakenly attributes the December 31, 1959

the interest. To make the required hypothetical determination, it is necessary to make assumptions about respondent's assets, liabilities, and other income which are consistent with its not receiving the tax-exempt interest. There would be fatal defects in the test, as we have shown in our opening brief, even if respondent's assumptions were correct. We content ourselves here with showing, as an additional point, that in fact the assumptions made by respondent, we will show, are wholly unrealistic, with the consequence that the comparison made by respondent provides a purely fanciful standard by which to determine the incidence of the tax.

Respondent had tax-exempt interest of $36,637, which, for the sake of round numbers, we will assume was produced by an investment of $1 million in municipal bonds. It acquired that $1 million to invest by selling life insurance policies, thereby incurring liabilities to policyholders the annual increase in which is the annual "cost" of the use of that money. If, in making the hypothetical determination required by respondent's argument, it is to be assumed that

---

figures to December 31, 1958 (Br. 56, n. 38). In December 1958, 2.5 percent—rather than 2.8 percent—of the companies' assets were in State bonds.

The most remarkable selection of figures, however, is found in the *amici's* comparison of the share of life insurance company assets invested in State bonds in 1940 with that in 1963 (Am. Br. 16, n. 1; 50, n. 2). Whether as a result of the wartime conditions of the securities markets or of enactment of the 1942 Act, company percentage holdings of State bonds plummeted from an all-time high in 1940 of 6.8 percent to an all-time low in 1947 of 1.2 percent. For the last fifteen years there has been a continuing increase in the share of company assets held in the form of State bonds.

respondent did not receive the $36,637 of tax-exempt interest, what is to be assumed about the $1 million of its assets it had invested in municipal bonds and about the liabilities to policyholders it had incurred to obtain the use of that money? There are at least three possible sets of assumptions that might be made to reconcile respondent's assets and liabilities with the assumed non-receipt of the tax-exempt interest:

(1) It might be assumed that respondent sold the same number of policies, incurred the same liabilities to policyholders, and had the same total assets, but invested the $1 million in taxable securities rather than in municipal bonds. In that event, even if it received no more income from the taxable securities than from the municipal bonds, its tax would have been greater, not less, than in the actual case.

(2) It might be assumed that respondent sold fewer policies, had correspondingly smaller liabilities to policyholders, and simply had $1 million less in total assets. In that event, respondent's taxable items of income would have been the same, but the deduction or exclusion for the required addition to the reserves would have been proportionately smaller, producing a tax liability substantially the same as that produced by the allocation formula in the actual case.

(3) It might be assumed—and this is what respondent does assume in its calculation—that respondent sold the same number of policies, incurred the same liabilities to policyholders, had the same total assets, but simply held $1 million of its assets in idle cash. It is only on that assumption that respondent's tax would have been less than that produced by the allocation formula.

The facts assumed by respondent to determine what its tax "would have been" had it not received the tax-exempt interest—the third assumption—are, it may be seen, wholly improbable as a matter of economic experience. A life insurance company does not incur liabilities to policyholders to obtain the use of their money simply in order to hold the money as idle cash, and a company which did so would soon be bankrupt. Realistically, the choice is between investing the money in municipal bonds *or* investing it in taxable securities. Moreover, in the unlikely event that a company did decide to reduce its total investments (*i.e.*, to reduce its holdings of municipal bonds but not increase its holdings of taxable securities), rationality would require it, rather than to hold idle cash, to undertake to reduce its liabilities to policyholders commensurately—*i.e.*, by not selling new policies to replace those cancelled or extinguished by payment of benefits. Thus the only assumptions consistent with the facts of economic life are the first two possibilities given above. If, then, the incidence of the tax is to be determined by comparing the tax with what the tax would have been without the tax-exempt interest, the hypothetical determination can meaningfully be made only by employing one of the first two assumptions. And on either of those assumptions, the fact is that respondent's tax would have been as great (on the second assumption) or greater (on the first assumption) without the tax-exempt interest as it was with it.

B. The comparison made by respondent is not only unrealistic but it is also precisely the comparison that

was rejected by this Court in *Deuman* v. *Slayton*, 282 U.S. 514, sustaining a disallowance of a deduction for interest paid on borrowed money that was invested in municipal bonds. It is simply not true, as *amici* state—except in the same sense that it is true here—that the taxpayer in that case "would not have had to pay [the interest] if he had not bought the bonds". (Am. Br. 28; see also Resp. Br. 45–46). He would not have had to pay the interest if he had not borrowed the money, but he *could* have borrowed the money, not bought the bonds, and simply held the money as idle cash, in which event he not only would have had to pay the interest but would have been entitled to deduct it. To be sure, it would be economic suicide for a taxpayer to borrow money, pay interest on it, and then not invest or otherwise use it. But just so would it be economic suicide for a life insurance company to incur liabilities to policyholders to obtain the use of their money and similarly fail to invest it. The assumption upon which the Court proceeded in *Denman* v. *Slayton* was that the taxpayer would have acted rationally and hence that, if he had not bought the bonds, he would not have borrowed the money in the first place. The equivalent assumption that must be made in this case is that, if respondent had not wanted to invest the $1 million, it would not have incurred additional liabilities to policyholders in order to obtain the use of the money in the first place.

The point is that the reserve addition "expense" involved in this case was just as much a marginal cost of holding the municipal bonds as was the interest expense in *Denman* v. *Slayton*. It is simply not true, as respondent asserts (Br. 46), that the reserve addition was a "fixed" expense that would have been incurred in all events. The level of a life insurance company's reserve liabilities is fully within its control and is determined simply by how much money the company wants to have available for investment. Nor is that true only historically, for the level of the reserve liabilities (and hence the amount of the required addition to the reserve) is affected to a significant extent by the company's actions in each taxable year: if it did not continue each year to sell new policies to replace those cancelled or extinguished, both its assets and its reserve liabilities would decline. Thus respondent specifically chose—by selling policies—to incur an additional reserve-addition "expense" in order to have available for investment the $1 million which it invested in municipal bonds. That additional expense, which it might have avoided by reducing its outstanding policies, was thus a marginal expense of holding the municipal bonds in precisely the same sense as was the interest expense in *Denman* v. *Slayton*—it was the cost, which would not otherwise have been incurred, of obtaining the use of

the money which respondent chose to invest in municipal bonds.[2]

Respectfully submitted.

ARCHIBALD COX,
Solicitor General.

LOUIS F. OBERDORFER,
Assistant Attorney General.

WAYNE G. BARNETT,
PHILIP B. HEYMANN,
Assistants to the Solicitor General.

MARCH 1965.

---

[2] In emphasizing that the addition to the reserve is in fact a marginal expense, we do not mean to suggest that a different result would follow if the addition were a fixed cost. In our original brief we showed that, when a fixed expense is attributable both to the cost of producing taxable income and to other purposes, it is proper to apportion the expense between its purposes and to allow a deduction only for that part of the expense properly allocable to the production of taxable income. It makes no difference whether the expense is the fixed cost of annual dues paid a country club which is used for both business and personal purposes (see Section 262 of the 1954 Code) or whether the expense is the cost of producing both taxable and tax-exempt income (see Section 265(1) of the 1954 Code). That is the holding of *Helvering* v. *Independent Life Ins. Co.*, 292 U.S. 371, which, in turn, relied upon *Denman* v. *Slayton*, 282 U.S. 514. It would fully dispose of the present case even if the reserve expense—the cost of using the reserve funds—were a fixed charge, allocated between the costs of producing taxable and tax-exempt income for the company.

U.S. GOVERNMENT PRINTING OFFICE: 1965